Supreme Court, U.S.
FILED

No. 94 423 SEP 7 1994

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In The

Supreme Court of the United States

October Term, 1994

ROSEMARY S. KOVACS; LOIS E. KOVACS;
KATHLEEN L. KOVACS,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari
To The Sixth Circuit Court Of Appeals

PETITION FOR WRIT OF CERTIORARI

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123 pp

QUESTION PRESENTED

Whether any portion of a lump-sum judgment recovered in a wrongful death tort action is taxable as income even though:

1) The same amount would be excluded from income under Section 104 of the Internal Revenue Code if received in periodic payments; and,

2) Code Section 104 specifically requires identical tax treatment, of the amount so received whether as a lump-sum or as periodic payments.

3) State law treats time value of money added (interest) as damages.

4) The widow and children of the decedent recovered less than the full amount of the verdict plus judgment interest due to delay in payments, because of the expense of recovery.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Rosemary S. Kovacs, Lois E. Kovacs and Kathleen L. Kovacs petition for a Writ of Certiorari to review the decision of the Sixth Circuit Court of Appeals, affirming the United States Tax Court, which held that there was a deficiency in Petitioners' income tax for the taxable year ending December 31, 1987 as determined by the Commissioner of Internal Revenue.

OPINIONS BELOW

The opinions of the Tax Court and the Sixth Circuit Court of Appeals are appended to this Petition in the Appendix. The opinion of the Tax Court is reported at 100 T.C. 124 (1993). The opinion of the Court of Appeals is unreported.

JURISDICTION

Respondent-Appellee, Commissioner of Internal Revenue, issued Notices of Deficiencies to Petitioners-Appellants on December 29, 1989 asserting deficiencies in income tax for the calendar year, 1987. Pursuant to 26 U.S.C. § 6213 (a), Petitions were timely filed in the United States Tax Court giving the Tax Court jurisdiction pursuant to 26 U.S.C. § 7442. Decisions of the Tax Court were entered on March 3, 1993, and a Notice of Appeal to the Sixth Circuit was timely filed pursuant to 26 U.S.C. § 7483 on April 23, 1993. Mary Ann Kovacs, one of the original

Petitioners, did not join in the appeal. This matter was appealable to the Sixth Circuit pursuant to 26 U.S.C. § 7482(b)(1)(A), as the Appellants are individuals legally residing in the State of Michigan. The Sixth Circuit entered its Opinion and Judgment on June 9, 1994. Petitioner invokes the jurisdiction conferred on this Court by 28 U.S.C. § 1254(1).

PRINCIPAL STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 104(a)(2) of the Internal Revenue Code, 26 U.S.C. 104, provides, in pertinent part, that gross income does not include:

> (2) the amount of any damages received (whether by suit or agreement and whether as lump-sums or periodic payments) on account of personal injuries or sickness.

Treasury Regulations, Section 1.104-1(c) state:

> "Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term 'damages' received (whether by suit or agreement) means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution."

Michigan Complied Laws 600.6013 states, in pertinent part, as follows:

(1) Interest shall be allowed on a money judgment recovered in a civil action, as provided in this section, except that for complaints filed on or after October 1, 1986, interest shall not be allowed on future damages from the date of filing the complaint to the date of entry of the judgment. As used in this subsection, "future damages" means that term as defined in section 6301.

(2) For complaints filed before June 1, 1980, in an action involving other than a written instrument having a rate of interest exceeding 6% per year, the interest on the judgment shall be calculated from the date of filing the complaint to June 1, 1980, at the rate of 6% per year and on and after June 1, 1980, to the date of satisfaction of the judgment at the rate of 12% per year compounded annually.

STATEMENT

The relevant facts, as stipulated by the parties, or otherwise reflected in the record are summarized as follows:

Charles L. Kovacs, Appellants' husband and father, died on September 30, 1976 as the result of injuries sustained when the truck he was operating was struck by a train owned by the Chesapeake and Ohio Railroad Company, ("the Railroad").

A Complaint was filed against the Railroad on September 25, 1978 under the Michigan Wrongful Death Act. After trial on May 28, 1982, the jury entered a verdict in the amount of $1,500,000, which pursuant to Michigan

Standard Jury Instruction (SJI 2d 53.03), had been reduced to present worth for future damages by 5 percent per annum in order to take into account the time value of money (interest). The jury also found comparative negligence of 33-1/3 percent which required the Trial Court to reduce the verdict to $1,000,000.

On June 18, 1982, the Trial Court entered its Judgment in the total amount of $1,355,777.40 computed as follows:

(A) The jury verdict was reduced by $5,000, per agreement of the parties, to $995,000.

(B) The Trial Court added $360,777.41 calculated as pre-judgment interest pursuant to M.C.L. Section 600.6013 from the date of filing the Complaint to the date of the Judgment.

On December 8, 1982, the Railroad filed a Claim of Appeal to the Michigan Court of Appeals and on May 14, 1984 the Court of Appeals affirmed the trial court's Judgment. The Railroad continued the appellate process to the Michigan Supreme Court. On December 16, 1986, the Michigan Supreme Court affirmed the Court of Appeals. Finally, on February 3, 1987, the Michigan Supreme Court denied the Railroad's motion for a rehearing which terminated the appellate process. On March 17, 1987, after exhausting all its appellate rights, the Railroad in satisfaction of the Judgment issued its lump-sum check for $2,254,741.70 for a tort that occurred in 1976. The proceeds of the Judgment were disbursed as follows:

a.	Attorney Fees	$749,535.72
b.	Costs Advanced	6,134.53
c.	Rosemary Kovacs-widow	999,380.96
d.	Mary Ann Kovacs-daughter	166,563.50
e.	Lois Elizabeth Kovacs-daughter	166,563.50
f.	Rosemary Kovacs, Conservator of the Estate of Kathleen Lynn Kovacs, a minor-daughter	166,563.50

REASONS FOR GRANTING THE PETITION

The decision of the Tax Court as adopted by the Sixth Circuit Court of Appeals is in conflict with the reasoning of this court in *United States v Burke*, 504 U.S. ___, 112 S. Ct. 1867 (1992), 92 USTC Para. 50,254 and other Circuits including the Tenth Circuit and is in direct conflict with the decision of the United States District Court for the District of Colorado in *Brabson v United States*, Civil action 93-K-2288 decided August 15, 1994. See Memorandum Opinion and Order by Senior Judge John L. Kane, Jr. appended to this Petition in the Appendix. The District Court in *Brabson* declined to follow the *Kovacs* majority and adopted instead the analysis of Judge Beghe in dissent. The issue is pending in several IRS Districts throughout the country and therefore is national in scope. The *Kovacs* majority is also contrary to the plain language of Section 104(a)(2) of the Internal Revenue Code. Moreover, it creates an enormous anomaly and inequity in the administration of the tax law that seriously alters the balance of power between litigants in all courts in the nation, state as well as Federal. Hence, the Tax Court and

Court of Appeals have decided an important question of Federal Law that has not been, but should be settled by this Court pursuant to Supreme Court Rule 10.1(c).

It is acknowledged by the parties that the damages were tort-type damages resulting from personal injuries (The Petitioners/Appellants are the widow and surviving daughters of Charles L. Kovacs who was killed in 1976 when the truck he was driving was struck by a train).

Had the Appellants (Plaintiffs in the original tort action that produced the damages at issue here) and the Railroad settled the earlier litigation, they would have been entitled to designate the amount they received as anything the parties chose. See *McShane v Commissioner*, 53 T.C.M. 409 (1987). A settlement amount, even if received many years after the original injury, generally does not designate or allocate any amount as interest even if the time value of money obviously had been considered. A settlement providing for periodic payments, including interest, (i.e. time frame value of money) is entirely tax free. The decision of the Tax Court and the Court of Appeals acknowledges that an amount, including the interest component, is tax free if split into periodic payments, even if split into only two payments. The only circumstance in which the "statutory interest" component of a tort judgment would be taxable would involve precisely the circumstances in this case, i.e. where the matter is pushed to trial judgment and paid in full by the Defendant. The result of the *Kovacs* majority is creation of judicial blackmail by shifting the balance of power between litigants thus enabling a Defendant to put intense pressure on the Plaintiff to settle because then and only then can arrangements be made to exclude the

time value of money portion of the judgment from income.

It is, of course, a matter of good public policy to encourage settlements, but the law as formulated by the *Kovacs* majority provides one-way pressure, only on Plaintiffs to settle. Defendants, particularly where large amounts are involved, are encouraged to fight to the bitter end if the Plaintiff will not agree to a greatly discounted award to avoid taxation on delayed time value added (interest).

Had the Railroad paid immediately after entry of the Trial Court's Judgment on June 18, 1982 (or, in fact, upon first demand by the Plaintiff's attorney) the amount paid would have been $1,355,777.40. They paid many years later $2,254,741.70 determined by applying a percentage to the amount obtained by judgment pursuant to Michigan statute which the Michigan legislature labeled interest. With respect to the *Kovacs* majority conclusion that the percentage amount was taxable interest, Senior Judge John L. Kane, Jr. in *Brabson v United States*, App. 86 stated:

> "The *Kovacs* majority invokes the following syllogism to conclude prejudgment interest awarded as damages in personal injury actions is not 'damages' excludable from income under § 104(a)(2): prejudgment interest is 'interest'; 'interest' is not 'damages'; therefore prejudgment interest is not 'damages' excludable from income under § 104(a)(2). The cornerstone of the majority's analysis, and the one without which it fails, is the conclusory maxim 'interest is interest.' This tautology withers under scrutiny, and I decline to follow it."

The conclusion that the interest portion of the lump-sum payment amount was taxable results in all tort cases tried before a Court or Jury, indistinguishable in principle from settled tort cases, being treated inconsistently. Most civil litigations are settled. Very few litigants can afford to pay off sizeable judgments with lump-sum payments. The end result of the holdings of the Tax Court and the Sixth Circuit is that a litigant who receives a judgment from a Defendant who is particularly wealthy and particularly stubborn has to pay taxes on one portion of the award, but other litigants in tort-type actions do not. This is poor public policy and, far from being mandated by statute, is diametrically opposed to the clear language of the statute which specifically states that payments of damages in tort-type actions, whatever their nature, are to be treated the same. A determination by this Court that the interest component in periodic payments are taxable would be consistent with the *Kovacs* decision; however, in view of the statute such determination obviously could not be made.

I

THE JUDGMENT AMOUNT INCLUDING ITS COMPONENTS SUCH AS "STATUTORY INTEREST" RECEIVED THROUGH PROSECUTION OF A LEGAL ACTION BASED UPON WRONGFUL DEATH IS EXCLUDED FROM INCOME UNDER SECTION 104(A)(2)

Section 104(a)(2) of the Internal Revenue Code provides that gross income does not include:

> "The amount of any damages received (whether by suit or agreement and whether as lump-sums

> or as periodic payments) on account of personal injuries . . . "

The Treasury Regulations, Section 1.104-1(c) states:

> "Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. *The term 'damages'* received (whether by suit or agreement) *means an amount received* (other than workmen's compensation) *through prosecution of a legal suit* or *action based upon tort* or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." (EMPHASIS SUPPLIED)

The Regulation's unequivocal definition of damages as an amount received through prosecution of an action based upon tort alone leads to the conclusion that any interest element which accrues during the prosecuting of a claim based upon tort should be treated as part of the damages award.

The parties agreed and the majority Tax Court opinion held that the Appellants' underlying claim was for a tort and that the "damages" were awarded on account of a personal injury. (Tax Court Op. App. p. 13). Therefore, there is no issue regarding whether the amount in question was received on account of personal injuries. The Tax Court majority opinion, however, construes the "statutory interest" added to the jury verdict pursuant to M.C.L. 600.6013 as entirely separate and distinct from the damages recovered by reason of the tort. Both dissenting opinions agreed that the "interest" at issue constitutes "damages" within the meaning of Code Section 104(a)(2) and the Regulations thereunder.

The Tax Court placed great reliance on the 1933 case of *Riddle v Commissioner,* 27 B.T.A. 1339, dealing with international law and claims resulting from the sinking of the Lusitania. See *Julia B. Bennett v Commissioner,* T.C. memo 1994-190 f.n. 5. In *Riddle* the then Board of Tax Appeals determined that interest could not accrue on an unliquidated personal injury award and that the only interest payable by law is that amount earned after the claim was liquidated. The "interest" accruing before the claim became liquidated would be amounts considered as damages because of the personal injury.

The Lusitania sank May 7, 1915 and the $15,000 award for personal injury was granted November 1, 1923. Interest on the liquidated claim ran from November 1, 1923 to 1928 when it was paid, not from the filing of the Complaint as in the instant case. Application of the *Riddle* principle to the instant case would mean that taxable interest on Appellants' claim ran from February 3, 1987 to March 17, 1987, the date of payment. As stated by Judge Beghe, the $30,000 interest accruing after finality of the Judgment would be taxable as Appellants conceded in the Tax Court proceeding. (Beghe Op. App. p. 35). *Riddle* does not stand for the proposition that pre-judgment interest is not excludable from gross income under Section 104(a)(2) but only that post judgment interest must be included in gross income (Beghe Op. App. p. 55).

The Tax Court's reliance on Michigan law for support was equally flawed. For 100 years or more, Michigan Courts have recognized that the failure to pay money promised when by law it ought to be paid authorizes the allowance of interest in the nature of damages for the improper detention of the sum so promised. *McCleary v*

Green, 38 Mich. 172, 185 (1878). That case held that interest is allowable as damages for non-payment of commissions when they were earned. Moreover, the Michigan Standard Jury Instructions make it clear that in a wrongful death action, interest as an element of damages may be awarded by the jury from the date of the deceased's death (the tort) to the filing of the Complaint. See Michigan Standard Jury Instruction SJI 2d 53.04. Under the rationale of the Tax Court "statutory interest" added by the Court would be taxed; however interest added by the jury from date of the tort to date of filing the complaint would be exempt. Thus, the "interest" element has been treated by the majority in diametrically opposed ways depending on what period of time the "interest" covers.

As indicated in Judge Beghe's dissenting opinion, the majority Tax Court opinion that Michigan law precludes a finding that "damages" received on account of wrongful death may include interest or a time value of money element is clearly erroneous. *Old Orchard by the Bay v Hamilton Mut. Ins. Co.*, 434 Mich. 244 (1990), 454 N.W. 2d 73, 76, cited in the Tax Court opinion does not support such conclusion. Moreover, the more recent Michigan Supreme Court opinion in *Gordon Sel-Way, Inc. v Spence Brothers, Inc.*, 438 Mich. 488 (1991), at page 499, conclusively shows that Judge Beghe's dissenting view is correct. The Michigan Supreme Court stated:

> "Finally, we acknowledge, as did the Court of Appeals, the fact that Michigan has long recognized the common-law doctrine of awarding interest as an element of damages. 177 Mich. App 128-131. The doctrine recognizes that

> money has a 'use value' and interest is a legitimate element of damages used to compensate the prevailing party for the lost use of its funds. See McCormick, Damages, Section 50, pp. 205-206. Furthermore, the decision whether to award interest as an element of damages is not dependent upon a contractual promise to pay interest. Id. See also *Mitchell v Reolds Farms Co.*, 268 Mich. 301, 313; 256 NW 445 (1934). As stated in *Banish v Hamtramck*, 9 Mich. App 381, 399-400; 157 N.W. 2d 445 (1968) the pivotal factor in awarding such interest is whether it is necessary to allow full compensation."

Indeed, the Michigan Supreme Court's language in the *Gordon Sel-Way* case is consistent in more than one respect with Judge Beghe's dissenting opinion. (See Beghe opinion, App. pages 37, 38, 43 *et seq.*).

The Tax Court's conclusion that damages and interest are separate items because the Michigan Wrongful Death Act does not repeat the provisions of Section 600.6013 of the Michigan Compiled Laws within its provisions, does not square with the legislative process. Michigan has at least three statutes which apply directly to the Kovacs case. M.C.L. 600.2922 is the Michigan Wrongful Death Act that describes the tort and as Judge Beghe noted (Beghe Op. App. p. 45-46), "There is nothing in subsection 6 of the Michigan Wrongful Death Act that prohibits a Michigan court or jury from including an interest (time value of money) element in its verdict so long as it is fair and equitable." M.C.L. 600.2922(6). Section 600.6306 determines the items included in the order of judgment, stating in salient part that "All taxable and allowable costs, including interest as permitted by Section 6013 or 6455 on

the judgment amounts" is included in the order of judgment. M.C.L. 600.6013 provides for the calculation of the interest element included in a judgment. It is not as the Tax Court majority claims a separately recovered amount.

The Supreme Court's decision in *United States v Burke*, 504 U.S. ___, 112 S. Ct. 1867, 92 U.S.T.C. Para. 50,254 (1992) supports Judge Beghe's well reasoned conclusions that:

> "This regulation covers all amounts received and does not distinguish among the component parts of an award received by a plaintiff in a tort action, such as lost future earnings, medical and funeral expenses, pain and suffering, loss of companionship, etc., or interest. Instead, the regulation focuses on the nature of the underlying claim. Once it is found that the personal injury claim is tort or tortlike, all amounts received from the defendant and its insurer through the prosecution of the claim are excluded from gross income." (Beghe Op. App. p. 42)

Threlkeld v Commissioner, 87 T.C. 1294, 1305 (1986) aff'd by the Sixth Circuit at 848 F.2d 81 (6th Cir. 1988) which required an investigation into the nature of the claim rather than the consequences flowing from the injury, was cited with approval by the Supreme Court in *Burke*. *Threlkeld* stands for the proposition that the essential element of exclusion is that the income be derived from some sort of tort claim. See also *Horton v Commissioner*, 100 T.C. 93, No. 8 (1993), CCH Dec 48,856 involving punitive damages.

As observed by Justice Blackmun in *Burke* at f.n. 6, 112 S. Ct. at 1871 the enactment in 1989 of a limited amendment of Section 104(a)(2) addressing exclusion of punitive damages only in the cases involving physical injury or sickness "shows that Congress assumed that other damages (i.e. compensatory) would be excluded . . ." In the body of the opinion Justice Blackmun further stated in pertinent part that: "Indeed one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate . . . fairly for injuries caused by the violation of his legal rights" 112 S. Ct. 1871. He further stated that the victim may be permitted under relevant state law, to recover damages not only for lost wages, medical expenses, and diminished future earning capacity on account of the injury, citing *Threlkeld*. A reasonable conclusion from *Burke* is that Judge Beghe's opinion should be adopted and the lower Courts reversed. Significantly, Judge Beghe's language (App. p. 43) stating that the "regulation covers all amounts received and does not distinguish among the component parts . . . such as loss of future earnings or interest" is almost identical with the language of Justice Blackmun.

The incompatibility of the majority Tax Court with the Supreme Court in *Burke* is most obvious. Moreover, the Supreme Court's specific approval in *Threlkeld* of the Sixth Circuit's analysis, in so far as it focused on the nature of the claim underlying the damage award, is added reason for reversal of the Tax Court, as affirmed by the Sixth Court.

In *Burke*, Justice O'Connor stated in her dissenting opinion:

> "The Court properly defers to an Internal Revenue Service Regulation that *reasonably* interprets the words "damages received" to mean "an amount received through prosecution of a legal suit or action based upon tort . . . "
>
> She then concluded that, "Therefore, respondents may exclude from gross income any amount they received as a result of asserting a 'tort type' right to recover for personal injury" 112 S. Ct. 1878.

Concurring in *Burke,* Justice Souter interpreted Regulation 26 CFR § 1.104-1(c) as reflecting "the broad dichotomy between contract and tort" 112 S. Ct. 1877. He then analyzed the claim in *Burke* to determine whether the remedies sought in that case were tort-like or contract-like. There is no question that the present case is a tort and none of the damages are contractual in nature. As no contractual damages exist in this case, it appears under Justice Souter's reasoning that the interest component of the amount received would not be taxable. The *Kovacs* majority's opinion is contrary to Justice Souter's opinion in *Burke.*

II

THE AMOUNT UNDER DISPUTE IS NOT "INTEREST" AS THAT TERM IS DEFINED IN THE TAX CODE

The cornerstone of the *Kovacs* majority analysis and the one without which it fails, is the conclusory maxim "interest is interest." As stated by Judge Kane in *Brabson v United States,* "This tautology withers under scrutiny" (App. p. 86).

Interest in the commercial sense generally would be calculated upon an ascertained or defined base. Under the facts of this case, the base upon which the statutory enhancement was calculated was inchoate, was not known, nor was it real until after exhaustion of the judicial process. In short, the base becomes choate and known only after the enhancement is achieved. To paraphrase the language of the Sixth Circuit in *Hettler Lumber Co. v Olds*, 242 F. 456, 460 (C.A. 6, 1917) prior to a certain time the right of the Appellants to demand anything of the Railroad was in the clouds.

In the instant case, there was no sum of money upon which "interest" could be computed until the finalization of the litigation by the Michigan Supreme Court. Thus, there could be no interest in the commercial sense.

Only by violently straining language can one say that the Appellants exercised forbearance with respect to the payment of their unadjudicated claim as in the case of taxable interest. Far more accurately, Appellants, upon filing the complaint, were entitled to nothing. They were exercising no forbearance at all. The Commissioner's arguments have been that merely because the Michigan Legislature provided that, with respect to any money judgment including actions for torts, the amount in question should be calculated as "interest" means that it cannot be considered as an element of damages within the meaning of Section 104(a)(2). That argument is patently unsound. The amount at issue was received as damages for personal injuries within the meaning of Section 104(a)(2) and the Regulations thereunder which have been outstanding for many years.

If the Commissioner's underlying argument that the amount at issue was to compensate for the delay in payment of a debt were valid, then the defendant railroad would be entitled to deduct the accrued interest under the decision of the Tax Court majority. However, as Judge Beghe observed, (Beghe Op. App. p. 38) such a deduction would not be permitted because "prejudgment interest included in an award on a non-contractual claim is not deductible by the payor as interest on indebtedness under Section 163(a) and its statutory predecessors." This is because there is no "debtor-creditor relationship" between the parties until the judgment is entered. It is only after a final judgment that Section 163(a) of the Code allows the defendant a deduction for interest paid or accrued on the judgment. After *Kovacs,* then, pre-judgment interest is "damages" not interest for purposes of the deduction for interest under Section 163(a); but it is "interest" not damages for purposes of the exclusion from income under Section 104(a)(2) (Brabson, App. 88).

While "interest" is income just as are wages, capital gains, and indeed, all accessions to wealth, the purpose of Section 104(a)(2) is to *exclude income* on account of personal injuries in order to make the injured party whole. The *Kovacs* majority taxes a portion of a protected recovery even though Appellants were not made whole.

III

RAMIFICATIONS OF THE PERIODIC PAYMENT SETTLEMENT ACT OF 1982

A.

NO DISTINCTION SHOULD BE DRAWN BETWEEN A LUMP-SUM PAYMENT INCLUDING AN INTEREST ELEMENT AND PERIODIC PAYMENTS INCLUDING INTEREST

Judge Halpern's dissent in the Tax Court holds that the Tax Court Majority has not properly taken account of Congress' 1982 amendment to Code Section 104(a)(2). The legislative history of the 1982 amendment makes it abundantly clear that the exclusion for periodic payments of damages on account of personal injuries is not limited to present value of such periodic payment but includes "interest." (Halpern Op. App. p. 24) That is to say that periodic payments, in their entirety, are excludable from gross income under Section 104(a)(2) as damages received from personal injuries. No allocation is allowed for that portion of the payments that represent the element or consideration for the use of money over time. Judge Halpern therefore properly concluded that lump-sum payments from prosecution of a law suit, including any interest component or element, likewise is fully excludable under Section 104(a)(2) as damages received on account of personal injuries.

There is no distinction and Congress did not provide for a distinction in tax treatment between a lump-sum

payment involving interest elements resulting from prosecution of a suit for tort from periodic payments involving the same elements derived from a settlement of a law suit for a tort.

All the Tax Court opinions agreed that the Periodic Settlement Act of 1982 was designed to codify and clarify existing law. All agree that under then existing case law and Revenue Rulings the exclusion for damages for personal injury did not exclude income or interest from a lump-sum award that was invested by or on behalf of the taxpayer. See *Revenue Ruling 76-133, 1976-1 C.B. 34; Revenue Ruling 65-29, 1965-1 C.B.59.* Thus, the application or non-application of Section 104 under the law as it existed in 1982 depends on whether the taxpayer has exercised control over the funds or has received an economic benefit from the funds.

Neither condition exists in the instant case. Appellants had no constructive receipt or economic benefit whatsoever until February 3, 1987 when the Michigan Supreme Court denied the Railroad's motion for rehearing. The Commissioner does not dispute that the Appellants did not have and could not exercise dominion and control over any liquidated or unconditional amount until 1987 (See *Revenue Ruling 79-220* and *Revenue Ruling 77-230.*) It was only after February 3, 1987 that the Commissioner could argue that Appellants had any economic benefit of the present value of the damages. Indeed, there was no principal sum, liquidated amount, or any unconditional amount that could generate interest until the appeal process became final.

The law, prior to the 1982 Amendment, was that portions of periodic payments representing interest on a fund invested on the recipients' behalf were not taxed so long as the invested funds were not actually or constructively received. Consequently, the Treasury Department argued at hearings before the Committee on Ways and Means, House of Representatives, 97th Congress, 2d Session regarding H.R. 5470, treatment of certain arrangements for periodic payment of personal injury damages that "the interest components of periodic damage payments should not escape taxation simply because the Plaintiff has elected in effect, to have the Defendant or a third party invest the proceeds of the settlement for him."

Although the Treasury's argument did not prevail, the Legislative history documents the Treasury's opposition to H.R. 5470 in the following discussion making clear references to the treatment of interest:

> " . . . this bill points out a serious problem under current law relating to the taxation of damages for personal injuries that are paid periodically rather than in a lump-sum. The problem arises from the fact that under current law, the portions of periodic damage payments representing interest on a fund invested on the recipient's behalf are not actually or constructively received."

Those remarks recognize that any interest element of damages would be excludable from gross income regardless of the characterization as long as the taxpayer had not actually or constructively received that portion of the periodic payment. In short, the criteria for exclusion then and now is whether the taxpayer had constructive receipt

of or economic benefit from the amount in question and not whether the amount reflected periodic payments or a lump-sum with elements of interest.

The importance of *Revenue Ruling 77-230, 1977-2 C.B. 214,* cited by the Tax Court majority (Op. App. p. 21) (involving excludability of medical payments from a Government trust for future medical expenses) is the side comment referring to Section 104(a)(2). The comments were " . . . benefits received through *distributions made from income or corpus* . . . in payment of medical expenses *are amounts received* through a settlement agreement in lieu of prosecution of a legal suit based upon tort . . . and therefore are excludable from income under Section 104(a)(2)." (Emphasis supplied). The Ruling then held that there should be no allocation for interest elements and the full amount of any periodic payment would be tax exempt.

Because investment interest received on a lump-sum is taxable, the logic prior to *Revenue Ruling 77-230,* was that a portion of each periodic payment made in place of a lump-sum settlement for personal injuries might be treated by IRS as taxable in the same way as an annuity payment especially because annuities were purchased to fund the payments. In order to reach the conclusion in *Revenue Ruling 77-230* there necessarily was recognition that any "interest" element in a lump-sum received prior to investment, constructive receipt or economic benefit was excluded under Section 104(a)(2).

Prior to the 1982 Amendment Section 104(a)(2) stated in salient part only that " . . . gross income does not include . . . (2) the amount of any damages received

(whether by suit or agreement) on account of personal injuries . . . " The language, *"and whether as lump-sums or as periodic payments"* was added by the 1982 amendment to clarify and codify existing law. It therefore follows that any "interest" element in a lump-sum received by way of settlement or prosecution of a tort action also was excluded.

The Tax Court majority apparently agreed with Judge Halpern's conclusion that the time value of money is to be disregarded and the entirety of periodic payments discharging an obligation for damages on account of personal injuries is excluded by virtue of the 1982 Amendment codifying existing law. However, the majority erroneously opined that the time value of money (interest) is not excluded where there is a one time (lump-sum) payment. This conclusion does not square with the language "whether as lump-sums or as periodic payments" added by Congress in the 1982 amendment. Therefore the "interest," or "statutory interest," is included within the broad range of damages to compensate Appellants such as "lost wages, medical expenses and diminished future earning capacity" as observed by Justice Blackmun in *Burke*.

B.

THE MAJORITY TAX COURT DID NOT PROPERLY TAKE ACCOUNT OF THE 1982 AMENDMENT TO CODE SECTION 104(A)(2)

The Tax Court and Sixth Circuit's Opinions with regard to the Periodic Payment Act ignores the point that it is a recognized principle of statutory construction that

a statute is to be construed so as to give effect to every word in it. If the Commissioner's interpretation as adapted by the Tax Court and the Sixth Circuit is allowed to stand, the "lump-sums" portion of the phrase, "and whether as lump-sums or as periodic payments," has no meaning.

The same argument that the interest portion is not "on account of personal injuries or sickness," not excludable, applies equally to the interest portion of periodic payments. Yet, the Commissioner did not attempt to argue that some portion of periodic payments are not "on account of personal injuries or sickness." Periodic payments, including the interest portion, are excludable. The same applies to "lump-sum payments." The wording of the statute makes it clear that payments of damages in tort actions, "whether as lump-sums or as periodic payments," are to be treated the same. In this connection Dissenting Tax Court Judge Halpern (App. p. 26-27) stated as follows:

> "Once it is understood that the 1982 amendment stands for the proposition that, with regard to periodic payments, the time value of money is to be disregarded, then the only remaining question is whether Congress intended any different result with regard to lump-sum payments. I believe that it did not and, consequently, whether payments are made periodically or in a lump-sum, time value of money considerations are to be disregarded in determining the taxability of amounts received under Section 104(a)(2). As stated earlier the language of the 1982 amendment supports that conclusion: 'whether as lump-sums or as periodic payments' suggests that Congress intended to disregard

> any difference between the two methods of payment."

The Commissioner suggested below that it is justifiable to treat identical receipts of funds differently for administrative convenience. Even if this were a good and sufficient reason (in fact, it is not) it is not even true. The Commissioner argued that state law controls the characterization of payments received in lawsuits and quoted Michigan law to the effect that the purpose of statutory interest is ***"to compensate the prevailing party for the delay in payment of money damages, to cover the costs of litigation and to encourage prompt settlement"*** (p. 21 of the Commissioners' Brief in the Court of Appeal). Accordingly, even under that view, not all of such statutory amount is payment for the time value of money under Michigan law. Some of it is to cover expenses and of course, as stated in *Gordon Sel-Way*, common law interest as damages shares the same full compensation goals of MCL 600.6013.

As with periodic payments, it is impossible to tell what portion of the "interest" is for what purpose lump-sum or periodic payment, the character of the payment is the same. How much is paid for what is impossible to disentangle. As stated by Tax Court Judge Halpern (App. p. 27-28):

> "For whatever reasons, Congress decided that it was best to disregard the fact that time value of money concerns play a role in determining the size of personal injury damage awards or settlement amounts, and to treat *no part* of *any* payment of damages received in connection with personal injuries as being on account of the time

> value of money. Thus, I would not distinguish between lump-sum payments and periodic payments with regard to time value of money considerations."

Yet, if this decision is allowed to stand, lump-sum payments and periodic payments, despite the mandates of the statue, would be treated differently.

As stated by Tax Court Judge Halpern (App. p. 28) treating periodic payments and lump-sum amounts differently with regard to interest "illustrates a patent inconsistency in the majority's interpretation of that amendment, whereby Congress decided for whatever reason, in connection with Section 104(a)(2) payments, to turn a blind eye to interest. We are obliged to respect that decision."

CONCLUSION

The petition for the Writ of Certiorari should be granted.

Respectfully submitted,

ROBERT B. PIERCE
DAN DARNELL
C. ROBERT BELTZ

NOT RECOMMENDED FOR PUBLICATION

No. 93-1637

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ROSEMARY S. KOVACS, et al.,	)	ON APPEAL FROM THE UNITED STATES TAX COURT
Petitioners-Appellants,	)	
v.	)	(Filed June 9, 1994)
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent-Appellee.	)	

BEFORE: NORRIS and DAUGHTREY, Circuit Judges, and GILMORE, Senior District Court Judge.*

PER CURIAM. In this appeal from the United States Tax Court, we are asked to decide whether interest paid on an award of damages for wrongful death is excludable as income under section 104(a)(2) of the Internal Revenue Code. That provision of the tax code excludes from gross income "the amount of any *damages* received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness. . . . " 26 U.S.C. § 104(a)(2) (emphasis added). "Interest," on the other hand, is included in gross income under section 61(a)(4) of the Code. 26 U.S.C. § 61(a)(4).

* The Honorable Horace W. Gilmore, Senior United States District Court Judge for the Eastern District of Michigan sitting by interchange.

The Tax Court upheld the Commissioner's determination that the amounts in dispute here were subject to taxation as gross income to the petitioners. We agree and affirm.

The facts in this case were stipulated in the Tax Court. The petitioners are the widow and three surviving daughters of Charles L. Kovacs, who was killed in 1976 when the truck he was driving was struck by a locomotive operated by the Chesapeake and Ohio Railroad Company. Suit for wrongful death was filed on behalf of his estate in Michigan state court, resulting in a 1982 damage award of $995,000. In 1987, after exhausting the appeals process, the railroad paid the petitioners a total of $2,254,741.70, which included the sum of the damages, plus $6,134.53 in costs and $1,253,607.17 in statutory interest.

After receiving their *pro rata* shares of the railroad's payment, the petitioners did not report any of the amounts as gross income (but also did not deduct any part of their attorneys' fees, totalling some $750,000, as expenses). The Commissioner subsequently notified the petitioners of substantial deficiencies for the tax year 1987, based on their failure to include as gross income the amounts calculated as interest on the original damage award. The taxpayers promptly petitioned the Tax Court for a redetermination, arguing that the interest in question was an element of damages under Michigan state law and, therefore, non-taxable as gross income.

In a split opinion,[1] the Tax Court upheld the Commissioner's determination and further held that the petitioners could deduct the attorneys' fees attributable to interest, under section 212(1) of the Internal Revenue Code. *See* 26 U.S.C. § 212(1). In doing so, the court analyzed in detail the federal precedents controlling the tax law questions raised in this case, relying principally on the Board of Tax Appeals's seminal opinion in *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933), and on the Tax Court's recent opinion in *Aames v. Commissioner*, 94 T.C. 189 (1990). It also analyzed Michigan statutory and case law precedents controlling the distinction between damages and interest as a matter of state law. Moreover, the majority opinion responded to the argument raised by the dissenters concerning the continued validity of *Riddle* and the propriety of *Aames* in light of the enactment by Congress of the Periodic Payment Settlement Act of 1982. That amendment to Internal Revenue Code section 104(a)(2) permits the exclusion of damages made by periodic payments, despite the possibility that such payments may include a time-value-of-money component that is arguably the functional equivalent of statutory interest. *See* 26 U.S.C. § 104(a)(2).

After careful study of the record and the opinions of the Tax Court in this case, we conclude that the majority opinion correctly analyzes the legal issues and reaches the proper decision on the narrow question presented.

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[1] Writing for the majority, Judge Ruwe was joined by 13 of his collegues, one of whom concurred in the result only. Four members of the Court dissented, but the two dissenting opinions proposed different results.

We, therefore, AFFIRM the judgment of the Tax Court on the basis of that opinion and for the reasons stated therein.

App. 5

UNITED STATES TAX COURT
Washington, D.C. 20217

ROSEMARY S. KOVACS, Petitioner	)	Docket No. 5617-90
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion (100 T.C. No. 10), filed February 24, 1993, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1987 in the amount of $220,572. It is further

ORDERED AND DECIDED: That there is no addition to tax due from the petitioner under section 6661, I.R.C., for the taxable year 1987.

/s/ Robert P. Ruwe
Robert P. Ruwe
Judge

Entered: MAR 3 1993

UNITED STATES TAX COURT
Washington, D.C. 20217

LOIS E. KOVACS, Petitioner	)	Docket No. 5618-90
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion (100 T.C. No. 10), filed February 24, 1993, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1987 in the amount of $34,992. It is further

ORDERED AND DECIDED: That there is no addition to tax due from the petitioner under section 6661, I.R.C., for the taxable year 1987.

(Signed) Robert P. Ruwe
Robert P. Ruwe
Judge

Entered: MAR 3 1993

UNITED STATES TAX COURT
Washington, D.C. 20217

KATHLEEN L. KOVACS, Petitioner	)	Docket No. 5620-90
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion (100 T.C. No. 10), filed February 24, 1993, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1987 in the amount of $30,184. It is further

ORDERED AND DECIDED: That there is no addition to tax due from the petitioner under section 6661, I.R.C., for the taxable year 1987.

(Signed) Robert P. Ruwe
Robert P. Ruwe
Judge

Entered: MAR 3 1993

100 T.C. No. 10

UNITED STATES TAX COURT

ROSEMARY S. KOVACS, ET AL.,[1]
Petitioners *v.* COMMISSIONER OF
INTERNAL REVENUE, Respondent

Filed February 24, 1993.

Docket Nos. 5617-90, 5618-90,
5619-90, 5620-90.

Ps were awarded damages of $995,000 in a Michigan wrongful death action and D appealed. After exhausting its appeals, D paid Ps $2,254,741.70, which was the sum of the damages, $6,134.53 in costs, and $1,253,607.17 in statutory interest. *Held*: Sec. 104(a)(2), I.R.C., excludes from gross income "damages received * * * on account of personal injuries". Statutorily imposed "interest" on damages is not included within the exclusionary terms of Sec. 104(a)(2). Ps may not exclude the portion of the payment representing interest. *Held further*: Ps may deduct the portion of their attorney's fees attributable to the interest.

Dan A. Darnell and *Robert B. Pierce,* for petitioners.

Lynn M. Brimer, for respondent.

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[1] Cases of the following petitioners are consolidated herewith: Lois E. Kovacs, docket No. 5618-90; Mary Ann Kovacs, docket No. 5619-90; and Kathleen L. Kovacs, docket No. 5620-90.

OPINION

RUWE, *Judge*: Respondent determined deficiencies in petitioners' 1987 Federal income taxes and additions to tax as follows:

Petitioner	Deficiency	Addition to Tax Sec. 6661
Rosemary S. Kovacs	$220,572	$55,143
Lois E. Kovacs	34,992	8,748
Mary Ann Kovacs	33,103	8,276
Kathleen L. Kovacs	30,184	7,546

Respondent has conceded the additions to tax under section 6661.[2]

The primary issue remaining for decision is whether "interest", which petitioners received pursuant to Michigan Compiled Laws (M.C.L.) section 600.6013 (1987), on "damages" that were awarded to them in a wrongful death action is excluded from gross income under section 104(a)(2). The deductibility of attorney's fees paid by petitioners will depend upon our resolution of the primary issue.

Petitioners resided in Fowlerville, Michigan, when they filed the petitions in this case.

The parties submitted this case fully stipulated pursuant to Rule 122. The stipulation of facts and attached exhibits are incorporated herein by this reference.

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Rosemary S. Kovacs is the widow of Charles L. Kovacs, who was killed in 1976 when the truck that he was driving was struck by a locomotive operated by the Chesapeake & Ohio Railroad Co. (C & O). On September 25, 1978, Mrs. Kovacs, as administratrix of her husband's estate, filed a complaint in the Livingston County Circuit Court against C & O and others in accordance with M.C.L. section 600.2922 (the Michigan wrongful death statute).

On May 28, 1982, a Livingston County Circuit Court jury delivered a verdict in favor of Mrs. Kovacs, awarding damages in the amount of $1,500,000, later reduced to $995,000.[3] The Michigan Court of Appeals affirmed, as did the Michigan Supreme Court. *Kovacs v. Chesapeake & Ohio Ry. Co.*, 351 N.W.2d 581 (Mich. Ct. App. 1984), affd. 397 N.W.2d 169 (Mich. 1986).

On March 17, 1987, C & O issued a check in the amount of $2,254,741.70, payable to Rosemary Kovacs, administratrix of the estate of Charles L. Kovacs, deceased, and C. Robert Beltz, her attorney. The check for $2,254,741.70 was full payment for damages in the amount of $995,000, $6,134.53 in costs advanced, and $1,253,607.17 in interest on the damages, pursuant to M.C.L. section 600.6013. Pursuant to M.C.L. section 600.6013, interest was calculated from the commencement

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[3] The original verdict of $1,500,000 was reduced one-third due to Charles L. Kovacs' contributory negligence and further reduced by $5,000 for an amount previously paid by the Board of Road Commissioners for the County of Livingston to settle claims against the board.

of the action until March 17, 1987, the date the judgment was satisfied.

By order of the trial court, Mrs. Kovacs received 66-2/3 percent from the net proceeds and her daughters, Lois, Mary Ann, and Kathleen, each received 11-1/9 percent. The total award of $2,254,741.70 was disbursed as follows:

Attorney's fees	$749,535.72
Costs advanced	6,134.53
Rosemary S. Kovacs	999,380.96
Mary Ann Kovacs	166,563.50
Lois Elizabeth Kovacs	166,563.50
Rosemary S. Kovacs, conservator of the Estate of Kathleen L. Kovacs, a minor	166,563.50

Petitioners did not report any part of the amounts received on their 1987 Federal income tax returns, nor did they deduct any part of the attorney's fees. Respondent determined that petitioners should have included the interest portion of the award in gross income. Respondent allocated the interest among the recipients in proportion to the percentages in the trial court's order. Respondent also determined that, under section 212(1), petitioners were entitled to miscellaneous itemized deductions, subject to the 2-percent floor provided by section 67, for attorney's fees attributable to the interest portion of the award. Respondent allocated the amounts of interest income and deductions for attorney's fees, after taking into account the 2-percent floor, as follows:

	Interest Income	Attorney's Fees
Rosemary S. Kovacs	$ 835,730	$260,961.16
Mary Ann Kovacs	139,290	43,448.67
Lois E. Kovacs	139,290	43,251.67
Kathleen L. Kovacs	139,290	43,637.67
Totals	$1,253,600	$391,299.17

Petitioners filed a timely petition with this Court.

Section 61(a)(4) provides that gross income includes "interest". See *Kieselbach v. Commissioner*, 317 U.S. 399, 403-404 (1943); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566, 1572 (1980); *Smith v. Commissioner*, 59 T.C. 107, 111-113 (1972); *Wheeler v. Commissioner*, 58 T.C. 459, 461-462 (1972); *Trez v. Commissioner*, T.C. Memo. 1976-141. Nevertheless, petitioners argue that the "interest" they received pursuant to M.C.L. section 600.6013 (1987)[4] is excludable from gross income under section 104(a)(2). Section 104(a)(2) provides that gross income does not include:

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[4] Michigan Compiled Laws (M.C.L.) sec. 600.6013 (1987), provides:

> (1) Interest shall be allowed on a money judgment recovered in a civil action, as provided in this section * * *
>
> (2) For complaints filed before June 1, 1980, in an action involving other than a written instrument having a rate of interest exceeding 6% per year, the interest on the judgment shall be calculated from the date of filing the complaint to June 1, 1980, at the rate of 6% per year and on and after June 1, 1980, to the date of satisfaction of the judgment at the rate of 12% per year compounded annually.

> the amount of any *damages* received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness; [Emphasis added.]

For damages to be excludable under section 104(a)(2), the taxpayer's underlying claim must be for tortlike personal injury. *United States v. Burke*, 504 U.S. ___, ___, 112 S. Ct. 1867, 1870 (1992) (quoting sec. 1.104-1(c), Income Tax Regs.). The underlying claim in the instant case is for wrongful death, which clearly lies in tort, see Prosser & Keeton, Law of Torts, sec. 127, at 945-960 (5th ed. 1984), and it is undisputed that the amount designated as "damages" was awarded on account of a personal injury.

Petitioners take the position that the term "damages" in section 104(a)(2) should be construed expansively so as to include interest on such damages. However, it is a longstanding rule of statutory interpretation that statutes providing exclusions from income must be construed narrowly. *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949). Section 104(a)(2) makes no mention of "interest". In order for us to accept petitioners' position – that interest on damages is excluded from income by section 104(a)(2) – we would have to interpret the term "damages" broadly and overrule previous opinions. This we decline to do.

There is no more persuasive evidence of the purpose of a statute than the words which the legislature used to give expression to its wishes. *United States v. American Trucking Associations*, 310 U.S. 534, 543 (1940). This maxim is especially true in interpreting tax statutes. *Crooks v. Harrelson*, 282 U.S. 55, 61 (1930); *United States v. Merriam*, 263 U.S. 179, 187-188 (1923); *Masonite Corp. v. Fly*, 194 F.2d 257, 260-261 (5th Cir. 1952). "[T]he words of statutes –

including revenue acts – should be interpreted where possible in their ordinary, everyday senses." *Crane v. Commissioner*, 331 U.S. 1, 6 (1947); *Miller v. Commissioner*, 93 T.C. 330, 338 (1989), revd. on other grounds 914 F.2d 586 (4th Cir. 1990). The term "damages" connotes the "compensation or satisfaction imposed by law for a wrong or injury". Webster's Third New International Dictionary (1986). The word "interest" in this context means "the price paid for borrowing [i.e., withholding] money". *Id.*[5] Petitioners had the right to, and did, demand payment of the damages when they filed their wrongful death claim. The Michigan courts upheld the validity of the claim and awarded damages plus statutory interest from the date the claim was filed. The statutory interest from the date on which petitioners filed their claim to the date of payment, therefore, falls within the established definition of interest.[6] In ordinary parlance, interest

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[5] See also *Kieselbach v. Commissioner*, 317 U.S. 399, 403-404 (1943) (interest constitutes "compensation for the delay in payment"); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566, 1572 (1980) (interest component of a condemnation award constitutes amount separate from price of condemned property); *Smith v. Commissioner*, 59 T.C. 107, 111-113 (1972) (interest as compensation for delay in payment).

[6] Cf. *Albertson's, Inc. v. Commissioner*, 95 T.C. 415 (1990), where we held that amounts which were deducted as accrued interest in a transaction that did not involve borrowing, withholding of amounts due, or forbearance from demanding payment were not properly characterized as "interest" because there was not, and never had been, a present right to claim the so-called principal amount. *Albertson's* involved employment contracts, wherein the employer and employees agreed, in advance of the performance of any services, that part of the employees' compensation would be deferred until retirement or

requires a principal sum. In the instant case, the damages are the principal sum on which the interest is owed, and ordinary usage suggests the two are separate. See 25 C.J.S., Damages, sec. 1(b) at 614 (1966) ("The term 'damages' is to be distinguished from other terms, such as 'debt', 'interest', 'penalty', 'salary', and 'value'.").

We last analyzed this issue in *Aames v. Commissioner*, 94 T.C. 189 (1990), in which we held that "interest" was not excludable under section 104(a)(2). In that case, the taxpayer had sued his attorney for malpractice for failing properly to prosecute the taxpayer's personal injury claim and was awarded damages and interest thereon. We drew a distinction between the damages and the interest on such damages, noting that the nature of interest is that it is paid because of the delay in the receipt of a principal amount. In *Aames*, the principal amount was the amount awarded as "damages". *Id.* at 193.

This issue first arose in *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933), which concerned the excludability of damages and interest awarded thereon in connection with personal injuries sustained during the sinking of the steamship *Lusitania*. The Board, applying predecessors of sections 61(a) and 104(a)(2) (subsections (a) and (b)(5),

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termination of employment. The amounts which were ultimately to be paid were characterized by the employer as deferred compensation plus interest. A deduction for interest on the amount designated as deferred compensation was taken by the employer prior to retirement or termination of the employees, even though the employees had never had a basis upon which they could have filed a claim demanding payment. Under those circumstances, we held that no part of the agreed-upon deferred compensation arrangement constituted interest.

respectively, of section 22 of the Revenue Act of 1928),[7] held that interest was not a part of damages, observing that the interest was "separately computed and specifically designated as interest * * * and as such is includable in income." *Id.* at 1341.

We have found no cases since *Riddle* was decided in 1933 which suggest that "interest" paid on an award of "damages" received on account of personal injury is excludable under section 104(a)(2). See *Church v. Commissioner*, 80 T.C. 1104, 1111 n.8 (1983), and *Roemer v. Commissioner*, 79 T.C. 398, 403-404 (1982), revd. 716 F.2d 693 (9th Cir. 1983), which both involved the exclusion of damages under section 104(a)(2), and in which there was agreement by the parties that interest was taxable.[8] Since *Riddle*, the exclusion for personal injury damages has

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[7] The Revenue Act of 1928, ch. 852, sec. 22(b)(5), 45 Stat. 791, 798, excluded from gross income the following:

> Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

[8] Cf. *McShane v. Commissioner*, T.C. Memo. 1987-151, which involved a one-time settlement payment for a personal injury. In excluding the full amount of that payment, we relied primarily on the taxpayers' testimony, which indicated that no interest or costs were included in the settlement payment. In addition, we reasoned that no unconditional obligation upon which to compute interest existed until the settlement agreement was reached. We noted, however, that "any statutory interest on the final judgment would have been taxable income under section 61."

been reenacted and amended numerous times.[9] Nevertheless, the statute continues to exclude only "damages" and omits any mention of "interest". This implies a continuing acceptance by Congress of the existing interpretation of the exclusion. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381, 382 & n.66 (1982) (longstanding judicial interpretation of statute approved by reenactment); see *Society of Plastics Indus. v. ICC*, 955 F.2d 722, 728-729 (D.C. Cir. 1992) (same).[10] Based on the foregoing, we hold that the statutory "interest" received by petitioners is not excludable as "damages received * * * on account of personal injuries" within the meaning of section 104(a)(2).

The relevant statutory and case law in Michigan is consistent with our holding. The claim underlying petitioners' interest award was brought under M.C.L. section 600.2922, entitled "Death by wrongful act; action for damages; liability." At common law, no cause of action for wrongful death existed in Michigan. *Hardy v. Maxheimer*, 416 N.W.2d 299, 305 (Mich. 1987) (citing *In re Olney Estate*, 14 N.W.2d 574 (Mich. 1944); *Hyatt v. Adams*, 16 Mich. 180 (1867)); accord *Fisher v. Volkswagenwerk A.G.*, 321 N.W.2d 814, 815 (Mich. Ct. App. 1982). Thus, petitioners' right to

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[9] See Periodic Payment Settlement Act of 1982, Pub. L. 97-473, sec. 101(a), 96 Stat. 2605; sec. 104(a)(2), I.R.C. 1954, 68A Stat. 30; sec. 22(b)(5), I.R.C. 1939, 53 Stat. (Part 1) 10. The most recent amendment to sec. 104(a)(2) was enacted by the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7641(a), 103 Stat. 2106, 2379.

[10] See also *Cannon v. Univ. of Chicago*, 441 U.S. 677, 696-697 (1979) ("It is always appropriate to assume that our elected representatives, like other citizens, know the law;").

"damages" for wrongful death stems solely from, and is limited to, what is provided by M.C.L. section 600.2922. See *Endykiewicz v. State Highway Commn.*, 324 N.W.2d 755, 757, 758 & n.2 (Mich. 1982). That statute enumerates several types of damages available for wrongful death in Michigan, including:

> reasonable medical, hospital, funeral, and burial expenses for which the estate is liable; reasonable compensation for the pain and suffering, while conscious, undergone by the deceased person during the period intervening between the time of the injury and death; and damages for the loss of financial support and the loss of the society and companionship of the deceased. * * * [M.C.L. sec. 600.2922(6).]

Petitioners received their interest pursuant to M.C.L. section 600.6013, which is a separate statute devoted solely to the "Interest rate on [the] judgment; [or] settlement." Under M.C.L. section 600.6013(1) and (2), interest is calculated on and added to the judgment and is designed to compensate the plaintiff for the loss of use of the monetary damages.[11] *McGraw v. Parsons*, 369 N.W.2d 251, 254 (Mich. Ct. App. 1985). Statutory interest under M.C.L. section 600.6013 accrues from the date the complaint was filed until the judgment is paid and is not a part of damages. *Vannoy v. City of Warren*, 182 N.W.2d 65,

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[11] Under the Michigan statute, interest is awarded as a matter of right upon entry of the judgment at a specified rate regardless of the type of claim or the importance of any element thereof. See M.C.L. sec. 600.6013 (1987) ("Interest *shall* be allowed on a money judgment recovered in a civil action, as provided in this section") (emphasis added).

69 (Mich. Ct. App. 1970), affd. 194 N.W.2d 304 (Mich. 1972); *Banish v. City of Hamtramck*, 157 N.W.2d 445, 451 (Mich. Ct. App. 1968); *Swift v. Dodson*, 149 N.W.2d 476, 478 (Mich. Ct. App. 1967). The distinction between "damages" and "interest" under M.C.L. section 600.6013 is further illustrated by the opinions of the Michigan Supreme Court and Court of Appeals in petitioners' case, in which the Courts' references to "damages" clearly do not include "interest" paid pursuant to the statute. *Kovacs v. Chesapeake & Ohio Ry. Co.*, 397 N.W.2d 169, 169 (Mich. 1986); *Kovacs v. Chesapeake & Ohio Ry. Co.*, 351 N.W.2d 581, 592 (Mich. Ct. App. 1984); see also *Old Orchard by the Bay v. Hamilton Mut. Ins. Co.*, 454 N.W.2d 73, 76 (Mich. 1990); *Denham v. Bedford*, 287 N.W.2d 168, 174 (Mich. 1980); accord *Ramada Dev. Co. v. U.S. Fid. & Guaranty Co.*, 626 F.2d 517, 523-526 (6th Cir. 1980).[12]

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[12] Historically, judges and commentators have debated over whether interest constitutes an award "in the nature of damages". See 25 C.J.S., Damages, sec. 51 (1966), and cases cited therein. The historically debated status of interest shows, at a minimum, that it has always been recognized as a concept with its own identity distinct from "damages".

> To permit an award of interest it is necessary that the claim for damages shall represent a pecuniary loss which is susceptible of computation with reasonable certainty, or by means of established market values or other generally recognized standards. [25 C.J.S., Damages, sec. 51, at 790 (1966)].

The cases in Michigan make clear that statutory interest computed from the date of filing a claim until payment pursuant to M.C.L. sec. 600.6013 is not a part of damages. See *Vannoy v. City of Warren*, 182 N.W.2d 65, 68 (Mich. Ct. App. 1970), affd. 194 N.W.2d 304 (Mich. 1972); *Swift v. Dodson*, 149 N.W.2d 476, 478 (Mich. Ct. App. 1967).

Finally, petitioners argue that the Periodic Payment Settlement Act of 1982, Pub. L. 97-473, section 101, 96 Stat. 2605, supports their position that interest is excludable under section 104(a)(2).[13] The purpose of this Act was to codify the position of the Internal Revenue Service as it existed at that time with respect to the excludability of damages received in periodic payments. The Internal Revenue Service's position was that section 104(a)(2) excluded personal injury damages, regardless of whether they were received in periodic payments or as a lump sum. S. Rept. 97-646 (1982), 1983-1 C.B. 514, 515. Petitioners seem to argue that since the amount of future periodic payments would normally be determined by taking into consideration the time value of money, it would be inconsistent to exclude the entire amount of such periodic payments while taxing petitioners on the "interest" that they received.

The legislative history indicates that the limited purpose of the Periodic Payment Settlement Act of 1982 was to "provide statutory certainty" for the exclusion of "damages" that are paid in "periodic payments." S. Rept. 97-646 (1982), 1983-1 C.B. 514, 515. Petitioners did not receive "periodic payments" of damages. Therefore, we perceive no relief that they can derive from the Periodic Payment Settlement Act of 1982, and certainly none from the revenue rulings cited in the legislative history to

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[13] The Periodic Payment Settlement Act of 1982, Pub. L. 97-473, sec. 101, 96 Stat. 2605, amended sec. 104(a)(2) by striking out "whether by suit or agreement" and inserting in lieu thereof "whether by suit or agreement and whether as lump sums or as periodic payments."

illustrate the legislative objective.[14] Any potential theoretical inconsistency that might arise between taxing statutorily imposed "interest" while excluding "periodic payments" of damages, some part of which may be attributable to the time value of money, is not within our province to remedy. If Congress perceives an inconsistency, and is dissatisfied with the result, it has the power to change the statute. In the meantime, it is our duty to apply the statutory language. Regarding the nonexcludability of interest, application of the relevant statutory language has been consistent since *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933), was decided in 1933.

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[14] The legislative history cites four prior revenue rulings dealing with settlements of personal injury claims. See S. Rept. 97-646 (1982), 1983-1 C.B. 514, 515. In Rev. Rul. 77-230, 1977-2 C.B. 214, periodic payments from a Federal Government trust for a taxpayer's future medical expenses were ruled fully excludable. In Rev. Rul. 79-220, 1979-2 C.B. 74, all periodic payments from an annuity contract purchased by a tortfeasor's insurer were ruled fully excludable. In Rev. Rul. 79-313, 1979-2 C.B. 75, 50 consecutive annual payments, to be increased by 5 percent each year, were ruled fully excludable. Finally, in Rev. Rul. 76-133, 1976-1 C.B. 34, involving a lump sum awarded in a personal injury suit, part of which was then ordered by the court to be invested on behalf of a minor until he reached majority, the interest earned on the investment was ruled *includable* in the minor taxpayer's gross income. What distinguished Rev. Rul. 76-133, *supra*, from the other three rulings was that the taxpayer in Rev. Rul. 76-133 was found to have had constructive receipt or the economic benefit of the damages at the time they were invested on his behalf. See S. Rept. 97-646 (1982), 1983-1 C.B. 515 nn. 2 and 3; Rev. Rul. 76-133, *supra*. It is clear from the legislative history that it was Congress' intent to provide "statutory certainty" that the type of "periodic payments" described in the first three rulings would continue to be excluded from gross income.

The legislative history of the Periodic Payment Settlement Act of 1982 states explicitly that "This provision is intended to codify, rather than change, present law." S. Rept. 97-646 (1982), 1983-1 C.B. 514, 515. Thus, the amendment effected no change to the longstanding precedent established in *Riddle*, wherein it was held that interest on personal injury damages is not excludable from income.

> where * * * Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute. [*Lorrilard v. Pons*, 434 U.S. 575, 581 (1978).]

Deductibility of Attorney's Fees

The parties have agreed that if we hold that petitioners' interest award is includable in income, the attorney's fees attributable to interest are deductible under section 212(1).[15] Because we have held that the interest is includable in income, petitioners will be allowed to deduct the portion of their attorney's fees attributable to interest. *Stocks v. Commissioner*, 98 T.C. 1, 18 (1992); *Metzger v. Commissioner*, 88 T.C. 834, 860 (1987), affd.

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[15] Attorney's fees attributable to the damages excludable from income are not deductible. Sec. 265(a); *Metzger v. Commissioner*, 88 T.C. 834, 860 (1987), affd. without published opinion 845 F.2d 1013 (3d Cir. 1988).

without published opinion 845 F.2d 1013 (3d Cir. 1988); *Church v. Commissioner*, 80 T.C. 1104, 1110-1111 (1983).[16]

Decisions will be entered for respondent as to the deficiencies in tax and for petitioners as to the addition to tax.

Reviewed by the Court.

HAMBLEN, PARKER, SHIELDS, COHEN, CLAPP, SWIFT, GERBER, WRIGHT, PARR, WELLS, CHIECHI, AND LARO, *JJ.*, agree with the majority opinion.

JACOBS, *J.*, concurs in the result only.

CHABOT, *J.*, dissents.

HALPERN, *J.*, dissenting. I dissent because I believe that the majority has not properly taken account of Congress' 1982 amendment to section 104(a)(2). See section 101 of the Periodic Payment Settlement Act of 1982 (the 1982 amendment), Pub. L. 97-473, 96 Stat. 2605, which struck from section 104(a)(2) the language "whether by suit or agreement" and inserted in lieu thereof the language "whether by suit or agreement and whether as lump sums or as periodic payments". The majority would treat the 1982 amendment as a narrow-purpose amendment, confirming only the application of the section 104(a)(2) exclusion to periodic payments of damages. Majority op. p. 10. I agree with the majority that the 1982 amendment confirms the application of the section

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[16] In *Church v. Commissioner*, 80 T.C. 1104 (1983), we used the following formula to determine the correct deduction:

$$\text{Total Attorney's Fees} \times \frac{\text{Nonexmpt Income}}{\text{Total Award}} - \text{Deductible Fees}$$

104(a)(2) exclusion to periodic payments of damages. I disagree with the majority, however, as to what Congress had in mind when it confirmed that application of section 104(a)(2).

The legislative history of the 1982 amendment makes it crystal clear that the exclusion for periodic payments of damages on account of personal injuries is not limited to the present value of such periodic payments. Periodic payments – *in their entirety* – are excludable from gross income under section 104(a)(2) as damages received on account of personal injuries. No allocation is allowed for that portion of such payments that represents consideration for the use of money over time, i.e., interest. I would hold that lump-sum payments, including any interest component, likewise are fully excludable under section 104(a)(2) as damages received on account of personal injuries. Certainly, the phrase "whether as lump sums or as periodic payments", which, in the statute, modifies the phrase "damages received", suggests that Congress intended to disregard any difference between the two methods of payment. Based on the 1982 amendment, I would hold for petitioners on the exclusion issue.[1]

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[1] Judge Beghe, in his dissent, informs us that petitioners have conceded the taxability of certain "postjudgment" interest. I would limit my holding for petitioners to "prejudgement" interest, saving the question of "postjudgment" interest for another day.

Interest Portion of Periodic Payments Excluded

The legislative history of the 1982 amendment states that the amendment was intended to codify, rather than change, present law:

> The bill specifically provides that the Code section 104 exclusion from gross income of damages for personal injuries or sickness applies whether the damages are paid as lump sums or as periodic payments. This provision is intended to codify, rather than change, present law. Thus, the periodic payments of personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments. See Rev. Rule 79-220, and Rev. Rul. 77-230.

S. Rept. 97-646 (1982), 1983-1 C.B. 514, 515; accord H. Rept. 97-832 (1982). As a preliminary matter, it is clear that the Finance Committee intended no change in the law of constructive receipt or in the economic benefit doctrine. See, e.g., Rev. Rul. 65-29, 1965-1 C.B. 59 (income realized from the investment of a lump-sum award representing the discounted present value of a damage award for personal injuries is not excludable from gross income under section 104(a)(2)). Therefore, two possibilities present themselves as to what the Finance Committee had in mind in confirming the application of the section 104(a)(2) exclusion to periodic payments. The committee may have intended that periodic payments of damages on account of personal injuries are to be received tax-free only until an amount equal to the present value of such periodic payments has been recovered, with the section

104(a)(2) exclusion thereafter being inapplicable, because exhausted. Alternatively, the committee may have intended that such periodic payments, in their entirety, are to be excluded from gross income. The committee's report is persuasive evidence of the latter. See S. Rept. 97-646, *supra*, citing four revenue rulings (described *supra* majority op. note 14) as illustrative of present law. Accord H. Rept. 97-832 (1982). The first three rulings amply illustrate that the Finance Committee intended the *entirety* of periodic payments received in discharge of an obligation to pay damages on account of personal injury to be received tax free. See, e.g., Rev. Rul. 79-220, 1979-2 C.B. 74 (present value at settlement date of monthly payments to be received less than nominal total of such payments; nominal total excluded from income under section 104(a)(2)). Indeed, the majority does not appear to disagree with that point.

Lump-Sum Payments

Once it is understood that the 1982 amendment stands for the proposition that, with regard to periodic payments, the time value of money is to be disregarded, then the only remaining question is whether Congress intended any different result with regard to lump-sum payments. I believe that it did not and, consequently, whether payments are made periodically or in a lump sum, time value of money considerations are to be disregarded in determining the taxability of amounts received under section 104(a)(2). As stated earlier, the language of the 1982 amendment supports that conclusion: "whether as lump sums or as periodic payments" suggests that

Congress intended to disregard any difference between the two methods of payment.

The revenue rulings cited in the legislative history of the 1982 amendment are of little help in resolving the question, their analysis being mostly conclusory and illustrating well only how to avoid receipt (for tax purposes) of the present value of the expected future payments. Certainly, the rule of exclusion for periodic payments is not limited to the three situations cited as illustrative of present law. Indeed, it appears indisputable that those examples are merely illustrative of some broader rationale on the part of Congress. The breadth of that rationale, however, is unclear. I perceive no persuasive evidence to explain Congress' distinguishing between lump-sum and periodic payments, as the majority suggests.

Congress, one might hypothesize, may have been concerned that a taxpayer accepting a periodic payment arrangement had accepted the credit risk that even the present value of the expected periodic payments would not be received. Revenue Rulings 79-220, *supra*, and 79-313, 1979-2 C.B. 75, are consistent with that conclusion. It is difficult, however, to see that concern as prompting the wholesale exclusion of periodic payments, which, as discussed earlier, the 1982 amendment clearly requires. Certainly, if that were Congress' concern, it would have been sufficient to exclude damages received only up until the principal portion of such damages is received. In trying to determine Congress' concern in adopting the 1982 amendment, I find myself in a puzzlement that I can only resolve by deciding that, for whatever reasons, Congress decided that it was best to disregard the fact that

time value of money concerns play a role in determining the size of personal injury damage awards or settlement amounts, and to treat *no part* of *any* payment of damages received in connection with personal injuries as being on account of the time value of money. Thus, I would not distinguish between lump-sum payments and periodic payments with regard to time value of money considerations.

I have no quarrel with the majority's distinction between a principal sum and interest. Majority op. p. 8. That distinction, however, appears to be irrelevant when dealing with damages received, whether by suit or agreement and whether as a lump-sum or periodic payment, on account of personal injuries. For purposes of section 104(a)(2), interest constituting a portion of such an award or settlement amount and attributable to the payment of damages for personal injury is to be treated no differently from what the majority would agree are damages on account of personal injuries. Treating periodic payments and lump-sum amounts differently with regard to interest does not, as the majority would have it, illustrate only a "potential theoretical inconsistency" wrought by Congress in enacting the 1982 amendment; it illustrates a patent inconsistency in the majority's interpretation of that amendment, whereby Congress decided, for whatever reasons, in connection with section 104(a)(2) payments, to turn a blind eye to interest. We are obliged to respect that decision.

Judges Beghe's Dissent

Judge Beghe also dissents from the opinion of the majority. Of course, I agree with Judge Beghe to the extent that he would exclude the entirety of petitioners' recovery based on the 1982 amendment. Beghe op. p. 45-47. I also agree with his rejection of application of the so called "reenactment doctrine" to this case. *Id.* p. 49. I disagree, however, with his conclusion that the sole condition for exclusion of a receipt under section 104(a)(2) is that the amount received (here prejudgment interest) constitutes "damages" within the meaning of that section. Judge Beghe reaches that conclusion based, in part, upon the following reading of *United States v. Burke*, 504 U.S. ___, 112 S. Ct. 1867 (1992): "Once it is found that the personal injury claim is tort or tort like, all amounts received * * * through the prosecution of the claim are excludable from gross income." Beghe op. p. 37.

Unlike Judge Beghe, I do not read *Burke* as standing for the proposition that *all* amounts received through the prosecution of a claim for a tort (or tort like) personal injury are excludable under section 104(a)(2). In *Burke*, the Supreme Court merely considered whether the type of injury redressed by title VII of the Civil Rights Act of 1964 (Title VII), Pub. L. 88-352, 78 Stat. 253, (current version at 42 U.S.C. sections 2000e to 2000e17 (1988)), is a "personal injury" within the meaning of section 104(a)(2). The Supreme Court did not have before it, nor did it

consider, the meaning of the term "damages" as used therein.[2] The Court's holding was as follows:

> Notwithstanding a common-law tradition of broad tort damages and the existence of other federal antidiscrimination statutes offering similarly broad remedies, Congress declined to recompense Title VII plaintiffs for anything beyond the wages properly due them – wages that if paid in the ordinary course, would have been fully taxable. *Thus, we cannot say that a statute such as Title VII,* whose sole remedial focus is the award of backwages, *redresses a tort-like personal injury* within the meaning of section 104(a)(2) and the applicable regulations.
>
> Accordingly, we hold that the backpay awards received by respondents in settlement of their Title VII claims are not excludable from gross income as "damages received . . . on account of personal injuries" under section 104(a)(2). * * * [*Id.* at ___, 112 S. Ct. at 1874; emphasis added; fn. ref. omitted; citations omitted.]

I therefore would hold that *Burke* sheds no light on the question of whether the interest at issue constitutes damages received on account of personal injuries within the meaning of section 104(a)(2).

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[2] The Court relied in part on sec. 1.104-1(c), Income Tax Regs., which defines "damages received". Justice Scalia, questioning the relevance of that regulation, noted: "this regulation purports expressly to define only the term 'damages received,' and not the * * * term we are called upon to interpret today ('personal injuries')". *United States v. Burke,* 504 U.S. ___, ___ 112 S. Ct. 1867, 1875 (1992) (Scalia, J., concurring) (citations omitted).

Nevertheless, I am prepared to agree with Judge Beghe that the interest at issue constitutes "damages" within the meaning of section 104(a)(2). Section 1.104-1(c), Income Tax Regs., is expansive in defining the term "damages" for purposes of section 104(a)(2): "The term 'damages received (whether by suit or agreement)' means an amount received * * * through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." However, unlike Judge Beghe (and perhaps many of my colleagues), I do not think the sole condition for exclusion contained in section 104(a)(2) is that an amount constitute damages received in a suit involving such tortlike personal injury. Another necessary condition contained in section 104(a)(2) is that the damages be received "*on account of* personal injuries or sickness". See *Horton v. Commissioner*, 100 T.C. ___, ___ (1993) (Whalen, J., dissenting). Absent the 1982 amendment, I would not be persuaded that that condition has been met. Indeed, the purposes of the Michigan statutory interest provision in question (Mich. Comp. Laws sec. 600.6013 (1987)) have been stated by the Michigan Supreme Court to be compensating for delay in payment of money damages, covering the costs of litigation, and encouraging prompt settlement. *Old Orchard by the Bay v. Hamilton Mut. Ins. Co.*, 454 N.W.2d 73, 76-77 (Mich. 1990). From that description alone, I would not conclude that the interest in question was received "on account of personal injuries or sickness." For that reason, without benefit of the 1982 amendment, I would not conclude that the requirements of section 104(a)(2) have been satisfied.

WHALEN, *J.*, agrees with this dissenting opinion.

BEGHE, *J.*, dissenting: I respectfully dissent. Statutory prejudgment interest on damages received on account of personal injuries is properly excluded from gross income under section 104(a)(2). I am impelled to this conclusion by the preexisting character of prejudgment interest on tort and other unliquidated claims *as* damages, for Federal income tax purposes and at common law and under such superseding statutes as Mich. Comp. Laws (M.C.L.) section 600.6013 (1987). This conclusion is supported by recent Federal income tax developments, including the Supreme Court's opinion in *United States v. Burke*, 504 U.S. ___, 112 S. Ct. 1867 (1992), our own reviewed decisions excluding from gross income under section 104(a)(2) punitive damages in personal injury actions[1] and settlements of claims to backpay in age discrimination suit[2], our treatment of amounts denominated "interest" under deferred compensation arrangements as deferred compensation subject to the deduction timing restrictions of section 404,[3] and the disregard of the interest element in both lump-sum settlements of claims for damages on account of personal injuries[4] and in deferred payment settlements governed by the amendment to section 104(a)(2) by the Periodic Payment Settlement Act of 1982, Pub. L. 97-473, 96 Stat.

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[1] *Horton v. Commissioner*, 100 T.C. ___ (1993); *Miller v. Commissioner*, 93 T.C. 330 (1989), revd. and remanded 914 F.2d 586 (4th Cir. 1990).

[2] *Downey v. Commissioner*, 97 T.C. 150 (1991); *Keller v. Commissioner*, T.C. Memo. 1991-373.

[3] *Albertson's, Inc. v. Commissioner*, 95 T.C. 415 (1990), on appeal (9th Cir., June 6, 1991).

[4] *McShane v. Commissioner*, T.C. Memo. 1987-151.

2605 (1982). As a result of these developments, "related principles of law have so far developed as to have left the old rule[5] no more than a remnant of abandoned doctrine",[6] so that neither stare decisis nor shopworn maxims about reenactment and narrow construction of exclusions from gross income require us to persist in following the old rule.[7] we should confine to their generative facts the decisions that have treated as ordinary income, rather than as part of the amount realized, amounts received for delay in receipt of condemnation awards.[8] Finally, the majority do not address some questions about proper allocation of the attorney's fees; the answers not only support the inapplicability of the condemnation cases to the primary issue in this case, but also indicate that a pro rata apportionment of such fees between the excludable and taxable parts of the award[9] is not the only way to go on this subsidiary issue.

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[5] Of *Aames v. Commissioner*, 94 T.C. 189 (1990); see also *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933).

[6] *Planned Parenthood v. Casey*, 504 U.S. ___, ___, 112 S. Ct. 2791, 2808-2809 (1992).

[7] Opposed to the thrust of each such maxim or canon of construction is a parry or counterthrust. See Llewellyn, The Common Law Tradition: Deciding Appeals, 521-535 (1960); *infra* pp. 48-52.

[8] *Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980); *Smith v. Commissioner*, 59 T.C. 107 (1972); *Wheeler v. Commissioner*, 58 T.C. 459 (1972); see also *Ferreira v. Commissioner*, 57 T.C. 866, 872 n.7 (1972).

[9] See, e.g., *Church v. Commissioner*, 80 T.C. 1104, 1110-1111 (1983).

I. Exclusion of Prejudgment Interest as Damages

A. Distinction Between Prejudgment and Postjudgment Interest

The way to get into this case is to observe that, on February 3, 1987, the Michigan Supreme Court, the State court of last resort, denied the C & O's motion for a rehearing. Prior thereto, petitioners had no legal right to recover on their claims, but on that date the judgment against the C & O in favor of petitioners became final, and petitioners' entire claim for damages, including statutory interest, was liquidated and became an indebtedness of the C & O to petitioners.

Petitioners argue that the "prejudgment interest" accruing to February 3, 1987, is part of the damages excludable from gross income under section 104(a)(2). However, petitioners concede that statutory interest accruing after that date, until March 17, 1987, when the C & O satisfied the judgment by issuing its check for $2,254,741.70, is "interest" includable in gross income under section 61(a)(4).[10] The concededly taxable interest

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[10] The thrust of Judge Halpern's dissent is that petitioners' concession should be disregarded and that, for cash basis taxpayers such as petitioners, the entire award received by them is entitled to exclusion under sec. 104(a)(2), and only the subsequent earnings on the amounts received and invested by them are properly taxable. Inasmuch as it was the income from investment of the proceeds of a personal injury or malpractice award that was at issue in *Trez v. Commissioner*, T.C. Memo. 1976-141, the citation of that case by the majority is inapposite (majority op. p. 5).

accruing from February 3, 1987, until the date of payment I call "postjudgment interest".[11]

I agree with petitioners that the statutory interest accruing to February 3, 1987, or "prejudgment interest", should be treated as part of the damages received on account of Mr. Kovacs' wrongful death.[12] Although a time

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[11] Petitioners have not provided a computation of the taxable amount, but, at the 12-percent compounded rate under Mich. Comp. Laws (M.C.L.) sec. 600.6013 (1987), it would appear to be approximately $30,000. This amount could be fixed on a Rule 155 computation.

[12] The trial court had awarded statutory interest under M.C.L. sec. 600.6013, calculated from the commencement of the suit, Sept. 25, 1978, through the date of its original judgment, June 18, 1982, in the amount of $360,777.41. The swelling of the interest amount included in the award finally paid on March 17, 1987, $1,253,607.17, is attributable not only to the passage of time, but also to the increase in the statutory rate under M.C.L. sec. 600.6013. Effective as of June 1, 1980, the statutory rate was increased from 6 percent per year to 12 per cent per year compounded annually. This raises the question whether the division date between prejudgment and postjudgment should be the date of the original judgment of the trial court or the later date on which the decision of the court of last resort became final. The question can have substantive law significance, e.g., for insurance law purposes. Compare *Matich v. Modern Research Corp.*, 420 N.W.2d 67, 75 n.15 (Mich. 1988) with *Incollingo v. Ewing*, 379 A.2d 79 (Pa. 1977). In any event, I think this question should be decided by reference to a Federal standard, see the discussion in *Fisher v. Commissioner*, T.C. Memo. 1992-740, and that the date the judgment becomes final should be the choice for Federal income tax purposes. I would choose the later date, when the judgment becomes final, as the division date, by analogy to the rule that an accrual basis taxpayer is not entitled to accrue a deductible claim until he ceases to contest it or the judgment becomes final. Compare *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961) with sec. 461(f).

value of money element inheres in both prejudgment and postjudgment interest, there is a long history of legal precedent that treats prejudgment interest on an unliquidated claim as part of the damages received on account of the injury that gave rise to the claim and the resulting right to receive such damages, see McCormick, Handbook on the Law of Damages, sec. 50, at 205 (1935), whereas postjudgment interest is considered interest eo nomine ("by that name"), Dobbs, Law of Remedies, sec. 3.5, at 164 (1973), because it accrues on an indebtedness that has been fixed by final court order.

Interest has been generally defined as the compensation allowed by law or fixed by the parties for the use or forbearance of money. See Black's Law Dictionary 812 (6th ed. 1990). While this definition applies to most types of interest, it fails to capture the nature of interest on damages arising from noncontractual claims. As Professor McCormick stated in his often-cited treatise on the law of damages: "This definition * * * is defective in ignoring interest allowed as compensation for delay in satisfying unliquidated claims." McCormick, *supra* at 205 n.1.[13] The defect is that interest (as compensation for the time value of money) is not simply a creature of contract,

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[13] Although Professor McCormick's treatise on the law of damages has remained unchanged since its publication in 1935, it continues to be cited as one of the leading authorities on the subject, particularly with reference to its exposition of the history of interest as an element of damages. See, e.g., *Monessen Southwestern Ry. v. Morgan*, 486 U.S. 330, 337 (1988); *Library of Congress v. Shaw*, 478 U.S. 310, 314 (1986); see also Williams, "Prejudgment Interest: An Element of Damages Not To Be Overlooked", 8 Cumb. L. Rev. 521 (1977).

but also may be an amount "allowed by law as additional damages for loss of use of the money due as damages, during the lapse of time since the accrual of the claim." *Id.* at 205.

Professor McCormick showed that there is an historical distinction between " 'conventional' or promised interest, on the one hand, and interest *as* damages, on the other." *Id.* at 206; (emphasis added; citation omitted); see also Dobbs, Law of Remedies, sec. 3.5 at 164 (1973); Black's Law Dictionary 812 (6th ed. 1990).[14] "[A] sharp distinction must be taken between interest which is agreed to be paid as one of the terms of a contract and interest not based on promise, but given by law for the withholding of money or compensation due." McCormick, *supra* at 205.[15]

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[14] See sec. 1.61-7(a), Income Tax Regs., for examples of conventional interest on various types of contractual and liquidated-claims. The list also includes one type of interest on what might be considered unliquidated claims, "the interest portion of a condemnation award". Sec. 1.61-7(a), Income Tax Regs.; see also *Kieselbach v. Commissioner*, 317 U.S. 399 (1943) (interest on condemnation awards), discussed *infra* pp. 52-54 and 58-59.

[15] The majority rule at common law was that prejudgment interest was not allowed on personal injury claims, at least with respect to pain and suffering and other nonfinancial harms. 4 Restatement, Torts 2d, sec. 913(2) (1979); McCormick, Handbook on the Law of Damages, sec. 50, at 205 (1935). Some jurisdictions allowed interest on lost wages between the time of the injury and the time of the verdict, just as they required lost future wages to be discounted to present value as of the time of the verdict. 4 Restatement, *supra* secs. 913(2) comment, 913A; McCormick, *supra* sec. 56.

Be that as it may, the Michigan statutory system for interest now applies to all types of claims without any distinction

B. Nondeductibility of Prejudgment Interest on Unliquidated Claims

To determine properly the income tax character of the amount awarded under M.C.L. section 600.6013, the Court should deconstruct the term "interest", rather than simply accept the contention that "interest is interest". The common law distinction between conventional interest and interest *as* damages is brought out by Federal income tax cases dealing with the deduction under section 163(a) for "interest paid or accrued * * * on indebtedness". These cases make clear that prejudgment interest included in an award on a noncontractual claim is not deductible by the payor as interest on indebtedness under section 163(a) and its statutory predecessors. This is because there is no debtor-creditor relationship between the parties until the judgment is entered. *Midkiff v. Commissioner*, 96 T.C. 724 (1991); *Bettendorf v. Commissioner*, 3 B.T.A. 378 (1926); see also *Jordan v. Commissioner*, 60 T.C. 872, 881 (1973), affd. per curiam 514 F.2d 1209 (8th Cir. 1975); cf. *Vertex Investment Co. v. Commissioner*, 47

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between contractual and noncontractual claims, and between pecuniary harms and other types of injury. M.C.L. sec. 600.6013 provides a legislative exception to the common law prohibition against interest as an element of damages and codifies the American trend favoring the award of prejudgment interest. *Ramada Development Co. v. U.S. Fidelity & Guaranty Co.*, 626 F.2d 517, 525 (6th Cir. 1980). However the jury is still instructed that it can include in the damages interest on financial claims accruing during the time from the date of the injury to the initiation of the lawsuit. *Ryan v. Ford Motor Co.*, 334 F. Supp. 674, 675-676 (E.D. Mich. 1971); *Vannoy v. City of Warren*, 182 N.W.2d 65 (Mich. Ct. App. 1970), affd. 194 N.W.2d 304 (Mich. 1972).

B.T.A. 252 (1942), vacated and remanded per curiam on other grounds 32 AFTR 1750, 43-2 USTC par. 9602 (9th Cir. 1943). However, the entry of final judgment on behalf of the plaintiff creates a debt, and section 163(a) allows the defendant a deduction for interest paid or accrued on the judgment. *Bettendorf v. Commissioner, supra.*[16]

C. Recent Developments

In *Albertson's, Inc. v. Commissioner*, 95 T.C. 415 (1990), on appeal (9th Cir., June 6, 1991), we held that amounts equal to interest accrued on unpaid deferred compensation were not deductible as interest under section 163(a) by the accrual basis employer. Rather, these amounts represented additional deferred compensation for personal services that were deductible under section 404 only when paid or otherwise included in the income of the employees.[17] The time value of money element in these amounts that arguably prevented them from having the character under section 162(a)(1) of "compensation for personal services actually rendered" did not prevent us from characterizing them consistently with the underlying statutory purpose of section 404. The teaching of

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[16] Subject, of course, to the current restrictions on the deductibility of personal interest under sec. 163(h) and the economic performance requirements under sec. 461(h).

[17] This is consistent with respondent's view that dividends on restricted stock that is not substantially vested under sec. 83, as to which the employee-stockholder has not made a sec. 83(b) election, are treated as compensation and not as dividend income. See Rev. Proc. 80-11, 1980-1 C.B. 616; cf. Rev. Proc. 83-22, 1983-1 C.B. 680; Rev. Proc. 83-38, 1983-1 C.B. 773.

Albertson's is that an amount that has a time value of money aspect can also take on another supervening character from the transaction or circumstances that gave rise to it.

Unlike conventional interest on indebtedness, prejudgment interest as damages takes its character from the originating claim; in this case a claim for physical personal injuries. In *Miller v. Commissioner*, 93 T.C. 330 (1989), revd. and remanded 914 F.2d 586 (4th Cir. 1990), we concluded that punitive damages on a personal injury claim took their character from the originating claim and were excluded from gross income under section 104(a)(2). We so held, despite the general rule of taxability of punitive damages as accessions to wealth enunciated in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), and the fact that something extra, the defendant's egregious conduct, was required in order to entitle the plaintiff to punitive damages. We recently reaffirmed that view in *Horton v. Commissioner*, 100 T.C. ___ (1993).

In *Downey v. Commissioner*, 97 T.C. 150 (1991), we held that a settlement of a claim for backpay on account of age discrimination and the liquidated damages added thereto were both excludable from gross income under section 104(a)(2). We so treated them even though the backpay portion restored amounts that would have been taxable compensation, and the liquidated damages in part compensated the plaintiff for delay in receiving the backpay under the Age Discrimination in Employment Act of 1967 (ADEA), Pub. L. 90-202, 81 Stat. 602-608. Similarly, statutory interest on a personal injury or wrongful death award compensates for the delay in payment. But like liquidated damages under the ADEA, and the punitive

damages in *Miller v. Commissioner, supra,* statutory interest under M.C.L. section 600.6013 also helps to compensate the plaintiff for costs and attorney's fees, see *Downey v. Commissioner, supra* at 172; *Old Orchard by the Bay v. Hamilton Mut. Ins. Co.,* 454 N.W.2d 73, 75-76 (Mich. 1990); *Denham v. Bedford,* 287 N.W.2d 168, 174 (Mich. 1980), as well as make the plaintiff whole. See *Currie v. Fiting,* 134 N.W.2d 611, 616 (Mich. 1965).

In *United States v. Burke,* 504 U.S. ___, 112 S. Ct. 1867 (1992), the Supreme Court stated that an amount will be treated as personal injury damages under section 104(a)(2) if it is received through prosecution of legal action based on a tort or tort type right or settlement in lieu thereof. *Id.* at ___, 112 S. Ct. at 1870 (citing sec. 1.104-1(c), Income Tax Regs.). The Supreme Court applied this rule to backpay awards received under title VII of the Civil Rights Act of 1964, Pub. L. 88-352, 78 Stat. 241, 253 (current version at 42 U.S.C sections 2000e to 2000e-17 (1988)), and held that such awards were not excluded from gross income under section 104(a)(2) because the Civil Rights Act did not provide a full panoply of tort remedies. Hence, the Court held that the rights protected by the statute were not tort or tortlike. *United States v. Burke,* 504 U.S. at ___, 112 S. Ct. at 1873-1874. In so holding, the Supreme Court agreed with the approach we adopted in *Threlkeld v. Commissioner,* 87 T.C. 1294, 1305 (1986), affd. 848 F.2d 81 (6th Cir. 1988), which looks to the tort or tortlike nature of the claim to determine whether damages were received on account of personal injuries. See also *Downey v. Commissioner, supra* at 160; *Glynn v.*

Commissioner, 76 T.C. 116, 119 (1981), affd. without published opinion 676 F.2d 682 (1st Cir. 1982). We should apply this approach to the case at hand.

The majority conclude, majority op. p. 8, that none of the interest portion of the award can be treated as damages because it serves a purpose fundamentally different from the underlying damages – compensating petitioners for the C & O's delay in payment. However, this overemphasizes the time value of money aspect of the recovery. The regulation under section 104(a)(2), section 1.104-1(c), Income Tax Regs., which was applied by the Supreme Court in *United States v. Burke, supra*, provides that:

> The term "damages received (whether by suit or agreement)" means an *amount received* (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. [Emphasis added.]

This regulation covers all amounts received and does not distinguish among the component parts of an award received by a plaintiff in a tort action, such as lost future earnings, medical and funeral expenses, pain and suffering, loss of companionship, etc., or interest. Instead, the regulation focuses on the nature of the underlying claim. Once it is found that the personal injury claim is tort or tortlike, all amounts received from the defendant and its insurer through the prosecution of the claim are excluded from gross income. See *United States v. Burke, supra; Downey v. Commissioner, supra; Threlkeld v. Commissioner,*

supra. Moreover, the regulation and court decisions interpreting section 104(a)(2) do not look to how the amount received would be treated for tax purposes outside the personal injury context. See *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), revg. 79 T.C. 398 (1982); *Downey v. Commissioner*, *supra* at 163-164; *Threlkeld v. Commissioner*, *supra* at 1300; see also Gideon, Lawsuits and Settlements, par. 103.04, at 314-315 (1992). Thus, this Court should be not bound by the "tyranny of labels"[18] to assume that an amount labeled "interest" must be treated as interest income for tax purposes when it is received through the prosecution (or settlement) of a tort or tortlike claim for personal injuries.

As the majority recognize, majority op. p. 6, petitioners' wrongful death claim against the C & O was for personal injuries, and sounded in tort. Consequently, under the Code and regulations, any amount petitioners received on account of that claim was "damages" for such personal injuries within the meaning of section 104(a)(2) and excludable from gross income regardless of how computed or its purpose of compensating for delay in payment.

D. Michigan Law

The majority state, majority op. pp. 11-12, that, under Michigan law, statutory interest is not an element of damages and therefore must be treated differently from interest awarded as an element of damages. As support

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[18] *Snyder v. Massachusetts*, 291 U.S. 97, 114 (1934) (Opinion of Cardozo, J.).

for this argument, the majority cite *McGraw v. Parsons*, 369 N.W.2d 251, 254 (Mich. Ct. App. 1985), in which the Michigan Court of Appeals observed that interest as an element of damages and statutory interest on a judgment are different because the former is awarded as part of the verdict and the latter is computed on and added to the underlying damages. The majority also argue that statutory interest must be included in gross income as ordinary interest because its purpose, like conventional interest on indebtedness, is to compensate the plaintiff for the lost use of funds and not for personal injuries or sickness.

The majority's reliance on *McGraw v. Parsons, supra*, is misplaced. In that case, a borrower and a lender had executed an interest-bearing note. The borrower stopped making payments on the note and the lender brought suit. The parties entered into a consent judgment. The trial court approved the consent judgment and awarded the lender interest under M.C.L. section 600.6013. The borrower argued that no additional interest should be awarded because the consent judgment already provided for interest as specified in the note. On appeal, the Michigan Court of Appeals held that statutory interest under M.C.L. section 600.6013 was mandatory and must be added to the consent judgment.

Although the Michigan Court of Appeals, in *McGraw v. Parsons, supra*, stated that the statutory interest served a purpose different from the interest provided in the consent judgment, that case concerned a liquidated claim for principal and interest, and arose out of a failure to make payments on an interest bearing note. The court therefore concluded, inasmuch as interest was already a part of the

parties' contract, and not a form of additional damages, that the plaintiff would not be collecting double interest. By contrast, Michigan courts do not permit plaintiffs in wrongful death cases, where the damages are unliquidated, to concurrently receive both interest as an element of common law damage and interest under M.C.L. section 600.6013. *Vannoy v. City of Warren,* 182 N.W.2d 65 (Mich. Ct. App. 1970).

According to the majority, "petitioners' right to 'damages' for wrongful death stems solely from, and is limited to, what is provided by M.C.L. section 600.2922," the Michigan Wrongful Death Act, majority op. p. 11. For this proposition the majority rely on *Endykiewicz v. State Highway Comm.*, 324 N.W.2d 755, 757, 758 & n.2 (Mich. 1982). Subsection 6, the damages provision of the Michigan Wrongful Death Act, provides that each damage award must *include*

> reasonable medical, hospital, funeral, and burial expenses for which the estate is liable; reasonable compensation for the pain and suffering, while conscious, undergone by the deceased person during the period intervening between the time of the injury and death; and damages for the loss of financial support and the loss of the society and companionship of the deceased. * * * [M.C.L. sec. 600.2922(6).]

The statute also provides that "the court or jury may award damages as the court or jury shall consider fair and equitable". M.C.L. sec. 600.2922(6).

There is nothing in subsection 6 of the Michigan Wrongful Death Act that prohibits a Michigan court or jury from including an interest (time value of money)

element in its verdict, so long as it's "fair and equitable". The indented language quoted above simply provides what must be included in the damages for wrongful death; it does not limit the damage award to those amounts or prohibit what may be included in addition to them. Moreover, the Michigan Supreme Court did not say anything in *Endykiewicz v. State Highway Commission, supra,*[19] that bears on the question before us other than the truism that the Wrongful Death Act provides "the sole vehicle for the recovery of damages occasioned by death." *Id.* at 758.[20]

In *Currie v. Fiting,* 134 N.W.2d 611, 616 (Mich. 1965), the Michigan Supreme Court held that interest may be included as an element of damages in a wrongful death action. Similarly, in *Vannoy v. City of Warren, supra,* the Michigan Court of Appeals recognized that interest awarded pursuant to M.C.L. section 600.6013 in a wrongful death case, although computed on and added to the underlying damages, serves the same purpose and is essentially equivalent to the common law interest made a part of the verdict in *Currie v. Fiting, supra.* Therefore, I

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[19] *Endykiewicz v. State Highway Commission,* 324 N.W.2d 755 (Mich. 1982), holds that the administratrix of a decedent's estate could sue under the Wrongful Death Act for damages for loss of companionship and society in an action that alleged that the State of Michigan breached its duty to maintain a highway in a reasonably safe condition even though the State had, in another statute, limited its liability for highway defects to bodily injury and property damage.

[20] As the majority observe, wrongful death is a purely statutory tort unknown at common law, majority op. p. 11. Prosser & Keeton, Law of Torts, sec. 127, at 945-947 (5th ed. 1984).

do not agree with the majority that Michigan law precludes a finding that damages received on account of wrongful death may include an interest, or time value of money, element.

The majority correctly observe that statutory interest is awarded under a separate statute from the basic wrongful death damages. Majority op. pp. 11-12. However, that does not dispose of the question before us. The statute providing for interest on damages, M.C.L. section 600.6013, applies to all types of damage awards, not just tort or wrongful death awards. All this means is that the Michigan legislature, for the sake of efficiency and convenience, enacted one interest provision rather than a series of different provisions for the many different types of civil actions. The fact that there is one interest provision and that it is separate does not mean that prejudgment interest cannot be a form of damages and that the interest element in a personal injury claim is not damages on account of personal injuries for Federal income tax purposes.

The majority point out that statutory interest is calculated on and added to the judgment. Majority op. pp. 11-12. In Michigan, when a plaintiff obtains a money judgment in any civil action, the plaintiff is automatically entitled to receive interest on the judgment under M.C.L. section 600.6013. No additional evidentiary showing is required. *Old Orchard by the Bay v. Hamilton Mut. Ins. Co.*, 454 N.W.2d 73, 75 (1990). However, this does not impede the Court from holding that, for tax purposes, statutory prejudgment interest on a tort claim is part of the underlying damages, rather than conventional interest eo nomine. By following respondent's approach, the Court has

ignored the fact that petitioners' right to receive interest on damages under M.C.L. section 600.6013 originated with and was inextricably tied to their right to be compensated for personal injuries. The fact that interest is computed on and added to the underlying damages is simply the way this additional amount is computed. Its tax character, however, is not properly determined solely by this characteristic.

E. Congressional Intent

The approach the Court should take in the case is consistent with the legislative purposes of section 104(a)(2),[21] insofar as they are currently understood. Although the original legislative history is scant, it suggests that Congress viewed compensation received for personal injuries or sickness as beyond the reach of the income tax. H. Rept. 767, 65th Cong., 2d Sess. 9-10 (1918), 1939-1 C.B. (Part 2) 86, 92; see *Downey v. Commissioner*, 97 T.C. 150, 157-158 (1991). One of the theories supporting the exclusion is that personal injury awards represent a return of "human capital" and thus simply make the victim whole by restoring him to the position he was in prior to the tortious injury. Hence, the recipient has no taxable gain inasmuch as he is no better off than he was prior to the injury. See *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1025 (1927); see also Chirelstein, Federal Income

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[21] The exclusion for damages received on account of personal injuries or sickness first appeared in the Revenue Act of 1918, ch. 18, sec. 213(b)(6), 40 Stat. 1057, 1066.

Taxation, sec. 2, at 40-41 (6th ed. 1991) (Recovery of Capital Investment).[22]

Another view is that the exclusion of personal damages is grounded in compassion for the victim. That is, "taxation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed." Harnett, "Torts and Taxes", 27 N.Y.U. L. Rev. 614, 627 (1952); see *Norfolk & Western Ry. v. Liepelt*, 444 U.S. 490, 501 (1980) (Blackmun, J., dissenting). However, the compassion justification has no sound theoretical foundation in tax policy. See Gideon, Lawsuits and Settlements, par. 103.04, at 314 (1990). Compassion for the victim of personal injury is not a tax reason for excluding damages from gross income. Instead, the exclusion stems from supervening nontax notions that tort victims should be compensated for pain and suffering and other damages and costs arising from personal injuries or sickness,

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[22] The human capital justification for sec. 104(a)(2) has been criticized as being inconsistent with other principles of taxation. Blackburn, "Taxation of Personal Injury Damages: Recommendations for Reform", 56 Tenn. L. Rev. 661 (1989); Dodge, "Taxes and Torts", 77 Cornell L. Rev. 143, 152-153 (1992). For example, if a person receives no damage award after being injured by another, that person is not entitled to a casualty loss deduction under sec. 165(c)(3). See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, par. 34 (1990). In *Downey v. Commissioner*, 97 T.C. 150, 159 (1991), we stated that it is doubtful "whether the return of capital theory justifies the exclusion from income of the full range of damages found to be excludable under section 104(a)(2), particularly damages received in lieu of lost income."

including lost wages and punitive damages, without paying tax on the recovery.[23]

1. Lump sum and periodic payment settlements. To exclude the interest portion of the award from gross income would be consistent with Congress' 1982 amendment to section 104(a)(2), which effectively codified three of respondent's revenue rulings[24] that a victim of personal injuries who receives damages in periodic payments, rather than as a lump sum, may exclude from gross income the entire amount of each payment, including the portion attributable to interest. Periodic Payment Settlement Act of 1982, Pub. L. 97-473, 96 Stat. 2605; H. Conf. Rept. 97-984 (1982), 1983-1 C.B. 522; S. Rept. 97-646 (1982), 1983-1 C.B., 514; see also H. Rept. 97-832 (1982). If Congress had intended to bifurcate personal injury damage awards into taxable and nontaxable components, it would not have specifically excluded from gross income the interest element of the periodic payments under structured settlements.

In addition, victims of personal injury who settle their claims may exclude from gross income amounts that the parties take account of as interest yet characterize as

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[23] The compassion justification has also been criticized on the ground that there is nothing in the legislative history of sec. 104(a)(2) that indicates that Congress intended to bestow a humanitarian benefit on taxpayers who received damages for personal injuries or sickness. See Dodge, *supra* at 148-149. However, in *Downey v. Commissioner*, *supra* at 158-159, we observed that the emotional justification for the exclusion was more satisfactory than the human capital approach.

[24] Rev. Rul. 79-313, 1979-2 C.B. 75; Rev. Rul. 79-220, 1979-2 C.B. 74; Rev. Rul. 77-230, 1977-2 C.B. 214.

damages in their settlement agreement. See *McShane v. Commissioner*, T.C. Memo. 1987-151.[25] There is no reason why the tax law should respect the exclusion of interest when it is received in a personal injury claim settlement that purports to disregard it, as in *McShane*, but not when it is received pursuant to a final judgment, as in this case.[26] In *Downey v. Commissioner*, 97 T.C. 150 (1991), we

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[25] In *McShane v. Commissioner*, T.C. Memo. 1987-151, the taxpayers settled their personal injury case while it was on appeal from a jury verdict in their favor, for an amount in excess of the basic damages awarded by the jury that obviously included prejudgment interest. We noted that the interest portion of the settlement would have been awarded as statutory interest under the applicable Massachusetts law had the case not been settled and the verdicts rendered in their favor proceeded to final judgment. We stated that it was "undisputed that if that had been the case, any statutory interest on the final judgment would have been taxable under section 61." However, this statement in *McShane* is dictum, because the issue of the taxability of interest on a judgment was not before us, and inapplicable here, because it appears to have been merely a statement of what the parties in that case did not dispute rather than a description of the applicable law.

[26] It might be argued that there is a public policy reason for favoring settlements by providing personal injury plaintiffs who settle with more favorable tax consequences than if they pursue their claims to final judgment. Insofar as this tax case is concerned, however, it could be improper for us to be distracted by what is essentially a local law consideration that already appears to have been adequately taken care of by the Michigan statute. The Michigan statute providing for judgment interest already has built-in provisions that are designed in a more discriminating way to favor settlement and to discourage parties who reject reasonable settlements and hold out for final judgment on the merits. M.C.L. sec. 600.6013(5), provides that if the plaintiff should reject a bona fide reasonable offer of settlement made by defendant, which is substantially identical to or

held that amounts received in settlement of an age discrimination suit were excludable under section 104(a)(2) and made no distinction between damages received by reason of a court or jury verdict and those received by reason of a settlement. This was in accord with the regulation interpreting section 104(a)(2), which specifically provides that no such distinction should be made. Sec. 1.104-1(a), Income Tax Regs.

Just as there is no reason to distinguish between damages and interest received by settlement and damages and prejudgment interest received by verdict, there is no reason to distinguish between interest when it is received in a lump sum or in periodic payments. The jurisprudence of this Court and Congress' 1982 amendment to section 104(a)(2) tell us that the interest component can be packed into an award for personal injuries and excluded from gross income, even though it is compensation for delay in payment.[27]

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substantially more favorable to the prevailing party than the ultimate judgment, then the court is not to allow interest beyond the time the written offer of settlement was made and rejected by the plaintiff, and filed with the Court. Similarly, if such an offer is made by the plaintiff and rejected by the defendant, the court shall order that interest be calculated from the date of the rejection of the offer to the date of satisfaction of the judgment at a rate of interest 2 percentage points higher than what the rate would have otherwise been.

[27] For a similar analysis that arrives at a contrary conclusion, see Abreu, "Distinguishing Interest from Damages: A Proposal For a New Perspective", 40 Buff. L. Rev. 373, 390 n.72 (1992).

2. Insurance proceeds analogy. The notions that underlie the statutory exclusion of personal injury damages, section 104(a)(2), also appear to underlie the total exclusion in section 101(a) of life insurance proceeds received on the death of the insured, including the portion of the proceeds attributable to interest on the investment in the contract (the "inside build-up"). Both statutory provisions permit recipients to exclude from gross income the interest that would otherwise be included in gross income, but which are received as result of personal calamity. See Chirelstein, Federal Income Taxation 39-41 (6th ed. 1991).[28]

3. Canons of construction. The majority argue that reading section 104(a)(2) to exclude interest on damages is contrary to the maxim that exclusions from gross income are to be narrowly construed. See *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949). However, I read the statute consistently with its broad and sweeping exception that "any damages" received on account of personal injuries are not included in gross income. See *Miller v. Commissioner*, 93 T.C. 330, 338, 340-341 (1989) (citing

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[28] A current example of the administrative application and extension of the compassion approach is the pending proposal to allow terminally ill beneficiaries (such as AIDS victims) of life insurance policies to draw down the proceeds free of income tax. Secs. 1.101-8, 1.7702-2, Proposed Income Tax Regs., concerning qualified accelerated death benefits, 57 Fed. Reg. 59319 (Dec. 15, 1992); see Pear, "Benefit Proposed for Terminally Ill – IRS would Allow Tax-Free Payment of Life Insurance While Person Is Alive", N.Y. Times, Dec. 16, 1992, at A-29. What this proposal appears to do is turn the interest earnings on the policy (the "inside build-up") into compensation for terminal illness under sec. 104(a)(2).

United States v. American Trucking Associations, Inc., 310 U.S. 534, 543 (1940)), revd. and remanded 914 F.2d 586 (4th Cir. 1990).[29] By enacting section 104(a)(2), Congress provided that amounts ordinarily includable in gross income, such as amounts equal to interest and lost wages, may be excludable when received as compensation for personal injuries suffered as a result of a tort or tortlike activity. See, e.g., *Downey v. Commissioner*, 97 T.C. 150, 163-164 (1991) (settlement of claim for backpay, including interest, received in an age discrimination suit under the ADEA excludable under sec. 104(a)(2)); see also Gideon, Lawsuits and Settlements, par. 103.04, at 313-314 (1990).

Nor should the doctrine of "reenactment" referred to by the majority, majority op. p. 10, impede us from properly deciding this case. There is no valid reason to believe that Congress reenacted the Board of Tax Appeals' decision in *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933), when it amended section 104(a)(2) in 1982 and 1989, much less when it enacted the Internal Revenue Codes of 1939,

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[29] Although our decision in *Miller v. Commissioner*, 93 T.C. 330 (1989), was reversed and remanded, 914 F.2d 586 (4th Cir. 1990), the fact that sec. 104(a)(2) is broadly worded has not changed, even since the statute's 1989 amendment after our decision in *Miller*. Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7641, 103 Stat. 2106, 2379 (amending sec. 104 to remove punitive damages for cases involving nonphysical injuries or sickness from the sec. 104(a)(2) exclusion). Moreover, our decision in *Miller* that the phrase "any damages" included punitive as well as compensatory damages was reversed on the ground that punitive damages were not received *on account of* personal injuries because they required an additional showing of egregious conduct by the defendant. *Commissioner v. Miller*, 914 F.2d at 589-592.

1954, and 1986. *Riddle* does not stand for the proposition that prejudgment interest is not excludable from gross income under section 104(a)(2), but only that postjudgment interest must be included in gross income.

Riddle concerned the taxability of postjudgment interest on a $15,000 award by the Mixed Claims Commission for personal injuries suffered by the taxpayer in the sinking of the *Lusitania* in 1915. The interest had accrued from November 1, 1923, the date of the award. The award was not paid until 1928, the taxable year before the Board. Under the rules of the Mixed Claims Commission, interest was not allowable from the time of loss, but only from the time the loss was fixed by the Commission. In these circumstances, the Board held that the interest was not excludable as part of the personal injury damages awarded by the Board, but was rather separately stated postjudgment interest and taxable as such.

Even if the majority properly read *Riddle* as supporting the proposition that all interest on damages for personal injuries, whether accruing before or after final judgment, is not excludable from gross income as damages, there is no reason to believe that Congress has ever reenacted the result or reasoning of *Riddle*. As the Supreme Court said in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955):

> It is urged that re-enactment of § 22(a) without change since the Board of Tax Appeals held punitive damages nontaxable in Highland Farms Corp., 42 B.T.A. 1314, indicates congressional satisfaction with that holding. Re-enactment – particularly without the slightest affirmative indication that Congress ever had

> the Highland Farms decision before it – is an unreliable indicium at best. * * * [Citations omitted.[30]]

The long-standing judicial view of this subject is, if anything, contrary to the majority's reading of *Riddle v. Commissioner, supra.* In a reviewed opinion of the Board of Tax Appeals, decided about 3 years after *Riddle, N.V. Koninklijke Hollandische Lloyd (Royal Holland Lloyd) v. Commissioner,* 34 B.T.A. 830 (1936), the Board held that no part of a damage award, which included interest as damages for delay is payment, was includable in the recipient's

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[30] In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran,* 456 U.S. 353, 381-382 (1982), cited in the majority op. p.10, the Supreme Court stated that:

> the fact that a comprehensive reexamination and significant amendment of the CEA left intact the statutory provisions under which the federal courts had implied a cause of action is itself evidence that Congress affirmatively intended to preserve that remedy. A review of the legislative history of the statute persuasively indicates that preservation of the remedy was indeed what Congress actually intended. [Fn. ref. omitted.]

Although Congress is presumed to be aware of judicial interpretations of a statute and to adopt them when it reenacts a statute without change, see *Albemarle Paper Co. v. Moody,* 422 U.S. 405, 414 n.8 (1975), it is highly unlikely that Congress had before it the issue in *Riddle v. Commissioner,* 27 B.T.A. 1339 (1933), when it reenacted sec. 104(a)(2) as it did when it reenacted the statute at issue in *Merrill Lynch.* Similarly, *Society of Plastics Indus. Inc. v. ICC,* 955 F.2d 722, 728-729 (D.C. Cir. 1992), and *Cannon v. Univ. of Chicago,* 441 U.S. 677, 696-697 (1979) (both also cited in the majority op. p. 10), concerned situations in which there was clear evidence or other indications that Congress was actually aware of the prior statutory interpretation that was in issue.

gross income. In that case, the Royal Holland Lloyd vessel *Zeelandia*, on a voyage from South America to Holland by way of New York, had been detained in New York harbor by Federal authorities from October 22, 1917, until March 21, 1918. Congress granted relief by allowing Royal Holland Lloyd to sue for compensation in the U.S. Court of Claims, which in 1931 awarded a recovery of $446,826.22, which was paid in 1932, the taxable year at issue, together with interest in the amount of $84,531.73. The Board first held that the basic award was not taxable, on the ground that "the sum received by the petitioner remains the payment of a judgment for damages and does not constitute rent 'from property located in the United States.' " *Id.* at 834. The Board then went on to hold that no part of the payment was interest from sources within the United States, on the ground that

> the "interest" was included in the judgment as part of just compensation for damages sustained. * * * Here, the stipulation denominated the sum of $84,531.73 as the "amount received for damages measured by interest" and in its opinion the Court of Claims stated: "The plaintiff is entitled to interest, as has been said, because such allowance is 'rightful' and is necessary adequately to compensate it for the damage." * * * Here the obligation of the United States is to make just compensation for the unlawful detention of the vessel. Just compensation for the damage so suffered requires that the party damaged be made whole. An integral part of a payment for such purpose is interest covering the period of detention. In such a case it is merely a convenient method of measuring the amount of one of the factors of damage. It is not

a separable item of interest on an obligation. *Id.* at 834-835; citations omitted.]

F. Authorities Arguably in Point

In reaching our conclusion in *Aames v. Commissioner*, 94 T.C. 189 (1990), we relied on cases dealing with interest on condemnation awards. *Id.* at 192 (citing *Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980); *Smith v. Commissioner*, 59 T.C. 107, 111-113 (1972); *Wheeler v. Commissioner*, 58 T.C. 459 (1972)). The question common to those cases was whether a taxpayer who had received a condemnation award could treat as capital gain, rather than as ordinary income, any interest or delay damages for the taking. Reviewing the taxability of a New York City condemnation award, the Supreme Court, in *Kieselbach v. Commissioner, supra*, held that any part of the amount received as "just compensation" that was payment for delay was ordinary interest income and would not receive capital gain tax treatment, even though paid as part of an award for the taking of a capital asset. As such, the interest was includable as ordinary income under a statutory predecessor of section 61(a)(4). *Id.* at 403.[31]

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[31] See also *Ferreira v. Commissioner*, 57 T.C. 866, 872 n.7 (1972), where, in holding "blight damages" under a condemnation award to be taxable ordinary income, we said: "Under *Kieselbach* we need not conclude that the payment is 'interest' as such. If the $26,000 award was made because of the delay in compensating the petitioners for the taking of their property, it constitutes taxable income." Cf. *Midkiff v. Commissioner*, 96 T.C. 724 (1991).

Absent section 104(a)(2) and its requirement that we focus on the tort or tortlike nature of the taxpayer's personal injury claim to determine the tax treatment of amounts received in compensation thereof, *United States v. Burke*, 504 U.S. ___, 112 S. Ct. 1867 (1992); *Downey v. Commissioner, supra; Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), affd. 848 F.2d 81 (6th Cir. 1988); sec. 1.104-1(c), Income Tax Regs., the reasoning in Kieselbach would not allow us to exclude the interest included in petitioners' award from gross income as damages for personal injuries. However, *Kieselbach* did not concern damages on account of personal injuries, and the Supreme Court, in that case, had no occasion to apply section 104(a)(2). Similarly, *Tiefenbrunn v. Commissioner, supra*, *Smith v. Commissioner, supra*, and *Wheeler v. Commissioner, supra*, do not concern section 104(a)(2) and therefore do not prescribe the rule to be applied under that provision.[32]

G. Stare Decisis

Insofar as *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933) and *Aames v. Commissioner, supra*, can be read to hold that all interest on personal injury damages is includable in gross income, we should no longer follow them.[33]

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[32] But see *Abreu, supra* at 388-389 (recognizing that prejudgment interest is damages but that it should be includable in gross income as compensation for delay in payment).

[33] Petitioners ask us to distinguish *Aames v. Commissioner*, 94 T.C. 189 (1990), on the ground that it involved not a suit for damages for personal injuries, but the taxpayer's malpractice claim against the attorney who negligently failed to obtain a proper settlement of the taxpayer's personal injury claim. It may also be noteworthy that the interest at issue in *Aames* did

Although we should not lightly decline to follow our precedents, *Riddle* and *Aames* are distinguishable in whole or in part from the case at hand, and have been undercut by recent developments. Therefore, taking the course I suggest would not violate the doctrine of stare decisis or any of its prudential and pragmatic underpinnings as outlined by the Supreme Court's plurality opinion in *Planned Parenthood v. Casey*, ___ U.S. ___, ___, 112 S. Ct. 2791, 2808-2809 (1992).[34] In any event, stare decisis is not an "inexorable command", *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 405-411 (1932) (Brandeis, J., dissenting),

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not begin to accrue until 8 years after the accident. I would not distinguish *Aames* on these grounds. The taxpayer's malpractice suit clearly had its origin in his claim for damages on account of personal injury, and there was some element of prejudgment interest in the award that he finally obtained. We should meet the issue head on and overrule *Aames* by announcing that we will no longer follow it with respect to prejudgment interest.

[34] In *Planned Parenthood v. Casey*, 504 U.S. ___, 112 S. Ct. 2791, 2808-2809 (1992), the Supreme Court stated that when it "reexamines a prior holding, its judgment is customarily informed by a series of prudential and pragmatic considerations designed to test the consistency of overruling a prior decision with the ideal of the rule of law, and to gauge the respective costs of reaffirming and overruling a prior case." The considerations are (1) "whether the rule has proved to be intolerable simply in defying practical workability"; (2) "whether the rule is subject to a kind of reliance that would lend a special hardship to the consequences of overruling and add inequity to the cost of repudiation"; (3)"whether related principles of law have so far developed as to have left the old rule no more than a remnant of abandoned doctrine"; and (4) "whether facts have so changed or come to be seen so differently, as to have robbed the old rule of significant application or justification". This case is governed by the third consideration set forth above.

but a principle of policy. Therefore, in light of latter-day related developments in the interpretation of section 104(a)(2) excluding from gross income backpay awards received in actions based upon tort or tortlike rights, as exemplified by *Rickel v. Commissioner*, 900 F.2d 655, 661-663 (3d Cir. 1990), affg. in part and revg. in part 92 T.C. 510 (1989), and *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990), revg. T.C. Memo. 1989-329, and to which we acceded in *Downey v. Commissioner, supra* at 168, this is an appropriate occasion to shift course. The correct interpretation of section 104(a)(2) is to exclude from gross income all amounts received through the prosecution of a personal injury claim based on tort or tort type rights. Sec. 1.104-1(c), Income Tax Regs. Under this interpretation, mandatory statutory prejudgment interest on damages received in a tort or tortlike action for wrongful death or other "personal injuries or sickness" is excluded from gross income.

II. Deductibility of Attorney's Fees

As the majority point out, the parties have agreed that if the interest portion of the award is includable in gross income, the attorney's fees allocable to the taxable interest are deductible under section 212(1). As a result, the deductible portion of the attorney's fees is not deductible "above the line" in arriving at adjusted gross income, and is subject to the 2- percent floor of section 67 because section 212(1) deductions are not among the "above the line" deductions enumerated in section 62.

Following respondent's lead, the majority cite *Church v. Commissioner*, 80 T.C. 1104, 1110-1111 (1983); *Metzger v.*

Commissioner, 88 T.C. 834, 860 (1987), affd. without published opinion 845 F.2d 1013 (3d Cir. 1988); and *Stocks v. Commissioner*, 98 T.C. 1 (1992), apparently for the proposition that the Church apportionment formula should be used to determine the correct deduction:

$$\text{Total Attorney's Fees} \times \frac{\text{Nonexempt Income}}{\text{Total Award}} = \text{Deductible Fees}$$

Petitioners did not argue this issue other than to preserve the point that, if any part of the interest should be held taxable, the attorney's fees allocable thereto would be deductible.

Although it might initially appear that the proper allocation of the attorney's fees is a cut-and-dried proposition, some aspects of the question do deserve further attention. It is not self-evident that a pro rata apportionment should be used to compute the deductible interest.

Petitioners' contingent fee agreement with the attorneys who represented them in the wrongful death action is not part of the stipulated record in this case. We do know that the total award of $2,254,741.70 was disbursed as follows:

Attorney's Fees	$ 749,535.72
Costs	6,134.53
Petitioners' Receipts (Gross)	1,499,071.45
Total	$2,254,741.70

It is clear that the agreed attorney's fees were one-third (33-1/3 percent) of the gross award, as it had been reduced by costs:

Gross Award	$2,254,741.70
Less: Costs	6,134.53
Net Award before Fees	3)2,248,607.17
Attorney's Fees	$749,535.72

At first blush, this computation would seem to confirm that a pro rata *Church* apportionment would be appropriate. The 33-1/3 percent attorney's contingent fee was calculated on the entire amount of the award, without any differentiation between the basic damages and the statutory interest. See sec. 265(a)(1). However, some additional observations are in order:

First, the fact that the attorney's contingent fee agreement did not differentiate between basic damages and statutory interest in computing the fee reinforces my view (expressed in Part I) that statutory interest on the basic damages is part of the damages for the purposes of the section 104(a)(2) exclusion. Second, the pro rata *Church* apportionment is not the only way to go. Two other possibilities deserve consideration: One would disallow any deduction for attorney's fees; the other would allow them as a deduction by applying them, dollar for dollar, up to (but not in excess of) the taxable interest portion of the award. There are authorities that could support either of these approaches.

Authority for total disallowance of the deduction is found in the treatment of attorney's fees paid to obtain condemnation awards. Inasmuch as the majority rely on *Kieselbach v. Commissioner*, 317 U.S. 399 (1943), and its progeny, see majority op. p. 5 and *supra* pp. 27, 52-54, to support their conclusion that statutory interest in this case is taxable as such rather than part of the excludable damages, authorities on the treatment of attorney's fees

to obtain condemnation awards may be relevant. This Court's view is that a property owner's expenses incurred to increase a condemnation award are capital expenditures because they fundamentally relate to the transfer of property. *Mosby v. Commissioner,* 86 T.C. 190 (1986); *Casalina Corp. v. Commissioner,* 60 T.C. 694, 703 (1973), affd. per curiam 511 F.2d 1162 (4th Cir. 1975). This has led to the surprising conclusion that, because such fees are capital expenditures, they may not be used to any extent to offset taxable interest awarded in the condemnation proceeding. *Madden v. Commissioner,* 514 F.2d 1149 (9th Cir. 1975); *Fulks v. Commissioner,* T.C. Memo. 1989-190. In *Fulks* we justified this conclusion on grounds that could be advanced to justify full disallowance of the attorney's fees in this case:

> Petitioners' attorney's fees were for services in connection with obtaining the jury award. Interest on the jury award accrued as a matter of right so that it cannot be said that the attorney's services made any direct contribution to the interest element. Thus there is no basis for allocating any part of the fee to the collection of interest. *Petit v. Commissioner,* 8 T.C. 228, 236-237 (1947). Therefore, the attorney's fees in this case were capital expenses deductible solely from the jury award. [Fn. refs. omitted.]

Our views on the treatment of attorney's fees in condemnation awards are at variance with our views on their treatment in personal injury actions. The views expressed in *Fulks* also do not apply to the facts of this case (even though interest accrues as a matter of right under the Michigan statute) because the fees obviously increased by 33-1/3 cents for each dollar of interest, a fact

that supports a pro rata apportionment of the fees. But this variance also casts doubt on the correctness of the majority's decision on the main issue in this case. The Court's lack of consistency in deciding the deductibility of attorney's fees in personal injury and condemnation cases reinforces my view that the condemnation cases do not prevent prejudgment interest in personal injury cases from being excluded from gross income as part of the damages.

Irrespective of whether the amount taxable is the postjudgment interest (approximately $30,000, see *supra* note 11), the amount by which the entire interest portion of the award exceeded the interest that accrued from the date of the original judgment ($1,253,607.17 - $360,777.41 = $892,829.76), or the entire interest portion of the award ($1,253,607.17), I think there is a proper basis for allowing the attorney's fees to be deducted, dollar for dollar, from the taxable interest. There is support for this approach under Michigan law, in that one of the rationales for statutory interest advanced by the Michigan Courts is that it helps to defray costs and attorney's fees incurred in order to obtain the award. *Old Orchard by the Bay v. Hamilton Mut. Ins. Co.*, 454 N.W.2d 73, 75-76 (Mich. 1990); *Denham v. Bedford*, 287 N.W.2d 168, 174 (Mich. 1980). This approach resonates sympathetically with our observation about the similar purposes of punitive damages in *Miller v. Commissioner*, 93 T.C. at 341. This approach would also be consistent with one of the possible methods of allocating the elements of the settlement referred to by the U.S. Court of Appeals for the Fourth Circuit in *Commissioner v. Miller*, 914 F.2d at 592, as an alternative to a pro rata

apportionment. Under this approach, the punitive damages awarded by the jury that the Court of Appeals held taxable could have been reduced dollar for dollar.[35] Analogous authority for such approach to allocating the attorney's fees between the taxable and nontaxable portions of the award could be found in *Fincke v. Commissioner*, 39 B.T.A. 510 (1939).[36]

In conclusion, I would hold: (I) That the prejudgment interest portion or the award is excluded from gross income under section 104(a)(2) as personal injury damages; and (II) that the attorney's fees are deductible dollar for dollar to the extent of the portion of the award included in gross income.

COLVIN, *J.*, agrees with this dissenting opinion.

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[35] Inasmuch as punitive damages are much more speculative, and subject to attack on appeal, it might be reasonable to expect that it was the punitive damages that were reduced by agreement of the parties in a post-trial pre-appeal settlement. But see *Miller v. Commissioner*, T.C. Memo. 1993-49 (on remand).

[36] *Fincke v. Commissioner*, 39 B.T.A. 510 (1939), applied basis in full to the sale portion of a part gift-part sale, a result that was made inapplicable to part charitable contributions-part sales of appreciated property by sec. 1011(b), enacted by the Tax Reform Act of 1969, Pub. L. 91-172, sec. 201(f), 83 Stat. 564. Compare sec. 1.1011-2, Income Tax Regs. with sec. 1.1015-4(a), Income Tax Regs.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Civil Action No. 93-K-2288

MARY BRABSON,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

MEMORANDUM OPINION AND ORDER
(Filed Aug. 15, 1994)

KANE, J.

Before me on defendant United States' motion to dismiss is the complex question of what constitutes "damages received on account of personal injuries or sickness" under the exclusion from gross income stated in Internal Revenue Code § 104(a)(2). In particular I must determine whether mandatory statutory prejudgment interest, added by operation of law to Colorado personal injury awards under C.R.S. § 13-21-101(1), is an element of "damages" excludable from income within the meaning of § 104(a)(2) or whether it is taxable "interest" within the meaning of § 61(a)(4).

Plaintiffs Mary, Helen, and William Brabson initiated this action against the United States alleging overpayment of their 1988 federal income taxes. The Brabsons claim they were erroneously taxed on the prejudgment interest portion of a personal injury award Mary Brabson obtained against the City of Colorado Springs and others

as a result of a gas explosion at the Brabsons' home in 1981. They seek recovery of the $ 371,000 in taxes assessed and paid on the portion of their damages award attributable to prejudgment interest, plus interest and attorney fees.

The United States moves to dismiss the Brabsons' complaint, asserting prejudgment interest is separate from damages and fully taxable as interest income. I disagree. Based on my review of the Code and caselaw interpreting it, I conclude mandatory statutory prejudgment interest is an element of compensatory "damages" available to plaintiffs pursuing personal injury actions under Colorado law. To the extent this conclusion conflicts with the Tax Court's recent ruling in *Kovacs v. Comm'r*, 100 T.C. 124 (1993), *aff'd in unpublished disposition*, 94 WL 253035 (June 9,1994), I decline to follow the majority's analysis, and adopt instead the dissent of Judge Beghe.

I. Facts

The following facts are undisputed:

On July 15, 1981, an explosion damaged Mary Brabson's home, injuring Mary and her children, William and Helen. The explosion was linked to a gas leak. Mary Brabson filed suit in El Paso County District Court, naming the City of Colorado Springs, Stratmoor Hills Water District, and Stratmoor Hills Sanitation District as defendants. The case was tried to a jury and a verdict rendered in favor of the Brabsons. On October 29, 1983, the trial court signed a judgment awarding Mary Brabson $ 1,502,150.02 for personal injuries,

$ 97,840.98 for property damage, and $ 341,159.10 in prejudgment interest from the date of the explosion to the date of judgment.

The defendants appealed. Before determination of the case by the Colorado Court of Appeals, the Stratmoor Hills defendants settled with Mary Brabson for $ 155,948.87. On November 26, 1986, the Court of Appeals issued an opinion affirming the trial court's judgment.

On February 17, 1987, the City of Colorado Springs filed a petition for writ of certiorari with the Colorado Supreme Court, seeking review of the Court of Appeals' decision. The petition was granted on May 11, 1987. On October 30, 1987, the Brabsons sought leave to execute partially on the judgment. The request was denied by the Colorado Supreme Court on November 10, 1987.

After oral argument on April 25, 1988, the Colorado Supreme Court ordered the petition for writ of certiorari denied as having been improvidently granted. On June 28, 1988, the parties filed a satisfaction of judgment in the El Paso County District Court indicating Mary Brabson received $ 2,888,414.06 in connection with her action against the City of Colorado Springs. Of this, $ 370,723.12 was attributed to mandatory statutory prejudgment interest on the personal injury award.

The Brabsons did not include the prejudgment interest as income on their 1988 federal income tax returns on grounds it constituted damages received on account of personal injuries under 26 U.S.C. § 104(a)(2). The Internal Revenue Service assessed income tax deficiencies against each of the Brabsons for the excluded prejudgment interest, which deficiencies the Brabsons paid. The Brabsons

now seek to recover the amounts paid, plus interest and attorney fees.

II. Discussion

As a general rule, "gross income means all income from whatever source derived." 26 U.S.C. § 61(a). All realized accessions to wealth are presumed to be taxable income, unless the taxpayer can demonstrate an acquisition is specifically exempt. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955); *Wulf v. City of Wichita*, 883 F.2d 842, 871 (10th Cir. 1989).

Since 1918 Congress has expressly excluded from gross income tort damages received on account of personal injuries. Revenue Act of 1918, § 213(b)(6), 40 Stat. 1066, *discussed in Roemer v. C.I.R.*, 716 F.2d 693, 696 (9th Cir. 1983) (footnote omitted). In its present form at 26 U.S.C. § 104(a)(2), the personal injury damages exclusion provides:

> § 104. Compensation for injuries and sickness.
>
> (a) **In general.**– Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable, year, *gross income does not include* –
>
> * * *
>
> (2) *the amount of any damages received* (whether by suit or agreement and whether as lump sums or as periodic payments) *on account of personal injuries* or sickness. . . .

26 U.S.C. § 104 (emphasis added).[1]

Treasury Regulation 1.104-1(c) defines "damages" in this context as "an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. § 1.104-1(c) (1991). With the exception of punitive damage awards,[2] excludability under § 104(a)(2) and Treasury Regulation 1.104-1(c) turns solely on the nature of the underlying claim, not the nature of the injury. *United States v. Burke*, ___ U.S. ___, 119 L. Ed. 2d 34, 44 (1992), *approving analysis in Burke v. United States*, 929 F.2d 1119, 1121 (6th Cir. 1991). If the underlying claim sounds in tort, that is "'the beginning and the end of the inquiry.'" *Burke*, 929 F.2d at 1121 (quoting *Threlkeld v. Comm'r*, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)); *Horton v. Comm'r*, 100 T.C. 93, 96 (1993) (citing *Burke*). The entire "amount received" through prosecution of that claim is excludable, regardless of whether it includes compensation for non-physical or economic losses, and *regardless of whether it includes elements of damages otherwise taxable.*[3]

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[1] Section 104, entitled "Compensation for injuries or sickness," also excludes from gross income amounts received for personal injuries or sickness under worker's compensation programs (§ 104(a)(1)), accident or health insurance (§ 104(a)(3)), and certain federal pension programs (§ 104(a)(4)).

[2] Punitive damage awards are excludable only if the underlying injury is physical. 26 U.S.C. § 104(a)(2) (after 1989 amendment). *See* 1989 Omnibus Budget Reconciliation Act, P.L. 101-239, 12/19/89 (applicable to punitive damage awards received after 7/10/89).

[3] *Horton v. Comm'r*, 100 T.C. 93, 95-6 (1993) (citing *Burke*) (punitive damages excludable); *Downey v. Comm'r*, 97 T.C. 150,

The exclusion from income under § 104(a)(2) thus is broad, as are the other exclusions in § 104 for "[c]ompensation for injuries or sickness." For example, the exemption for "amounts received" through accident or health insurance for personal injuries or sickness (26 U.S.C. § 104(a)(3)) excludes from income *all* amounts received under accident or health insurance policies, even if they are in excess of the insured's actual medical expenses (Rev. Rul. 58-602, 1958-2 C.B. 109), and even if they include items otherwise taxable, such as replacement income (Rev. Rul. 58-90, 1958-1 C.B. 88). *See* 4 U.S. Tax Rep. ¶ 1044.03.[4]

The Tenth Circuit recognizes the breadth of the exclusion in § 104(a)(2). Once it is determined an underlying claim sounds in tort, the Tenth Circuit has ruled the entire

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160 (1991) (§ 104(a)(2) excludes from income all damages that substitute for items otherwise taxable or would produce taxable benefit). *See Redfield v. Ins. Co. of North America*, 940 F.2d 542, 545 (9th Cir. 1991) (economic damages received in ADEA case fully excludable, even though based on otherwise taxable lost wages) (adopting view taken by Third and Sixth Circuits in *Pistillo v. Comm'r*, 912 F.2d 145 (6th Cir. 1990) and *Rickel v. Comm'r*, 900 F.2d 655 (3d Cir. 1990)); *Threlkeld*, 848 F.2d at 84 (all amounts received in compensation of nonphysical personal injury, like amounts received for physical injury, excludable under § 104(a)(2)); *Roemer v. C.I.R.*, 716 F.2d 693, 697 (9th Cir. 1983) (Tax Court erred in requiring amounts received for nonphysical injuries in defamation action allocated into taxable and nontaxable components).

[4] However, the general exclusion in § 104(a)(3) does not apply to amounts received by an employee to the extent the amounts are either attributable to employer contributions not includable in the employee's gross income, or paid by the employer. *See* 4 U.S. Tax Rep. ¶ 1044.03.

amount awarded as damages for personal injuries is excluded under § 104(a)(2). *Wulf v. City of Wichita*, 883 F.2d 842, 873 (10th Cir. 1989). In *Wulf*, the court of appeals reversed the trial court's addition of $ 80,821.97 to a damages award for "taxes due," finding the trial court had erroneously assumed the damages award, which represented back pay, was taxable. Because the underlying claim – i.e. termination of plaintiff's employment deprived him of his First Amendment rights in contravention of 42 U.S.C. § 1983 – sounded in tort, the Tenth Circuit found the entire damages award excludable from income under § 104(a)(2). *Id.*

> The award of back pay compensated [plaintiff] for the economic injury resulting from the denial of his constitutional rights. It is still an award of damages 'on account of personal injuries,' and is therefore not taxable.

Id. (citing *Bent v. Comm'r*, 835 F.2d 67, 71 (3d Cir. 1987) (rejecting Commissioner's argument that portion of settlement based on lost wages not excludable from income under § 104(a)(2) because wages otherwise taxable)).

Applying this analysis to the case before me, I first look to the nature of the underlying claim. There is no dispute the Brabsons' suit against the City of Colorado Springs and the Stratmoor water and sanitation districts was a legal action based upon tort. Nor is there a dispute that the prejudgment interest at issue was part of the "amount received" by the Brabsons through prosecution of that action. *See* Treasury Reg. 1.104-1(c).

This alone should be the end of the inquiry. *Kovacs v. Comm'r*, 100 T.C. 124, 145-46 (1993) (Beghe, J. dissenting)

(citing *Burke, supra,* 119 L. Ed. 2d 34; *Downey, supra,* 97 T.C. 160-63; *Horton, supra,* 100 T.C. at 96). The United States, however, argues the relevant inquiry is not whether the prejudgment interest was an "amount received" by the Brabsons through prosecution of Mrs. Brabson's personal injury action, but whether it constitutes "damages" as contemplated in § 104(a)(2). Def.'s Mot. Dismiss at 7. The answer to this question, I find, requires consideration of Colorado personal injury law and a determination of how Colorado views prejudgment interest awarded under C.R.S. § 13-21-101.

A. *Colorado law determines what "damages" are available in Colorado personal injury actions.*

Because there is no general federal common law of torts (*Erie Railroad Co. v. Tompkins,* 304 U.S. 64, 78 (1938)) nor controlling definitions in the Tax Code, courts interpreting § 104(a)(2) look to state law. *Roemer v. Comm'r,* 716 F.2d at 697, *citing United States v. Mitchell,* 403 U.S. 190, 197 (1971) (quoting *Burnet v. Harmel,* 287 U.S. 103, 110 (1932) (state law creates legal interests, federal law determines when and how to tax)). Consideration of state law is not limited to determining whether a particular action sounds in tort; courts also look to state law to determine the types of "damages" available to the plaintiff in such an action.

Where, under state law, the damages redress the personal injury suffered by the plaintiff, they are excludable under § 104(a)(2). *See Roemer,* 716 F.2d at 700 (all compensatory damages available under California law for defamation excludable from income under

§ 104(a)(2)); *Horton v. Comm'r*, 100 T.C. 93, 100 (1993) (in Kentucky, punitive damages serve "both to compensate the injured party and punish the wrongdoer" and are excludable under § 104(a)(2)); *Burford v. United States*, 642 F. Supp. 635, 638, n.5 (N.D.Ala. 1986) (though labeled "punitive," Alabama wrongful death awards compensate plaintiff for her loss and thus are excludable from income), *discussed in Miller, supra*, 914 F.2d at 591 (in contrast to *Burford* court's examination of Alabama wrongful death law, examination of Maryland law indicates punitive damages in Maryland defamation action are not awarded compensatory).

Where, under relevant state law, damages are received for some other purpose, they are not excludable under § 104(a)(2). *See Reese v. United States*, 24 F.3d 228, 232 (Federal Circuit concluded punitive damage awards for violation of the District of Columbia Human Rights Act are to deter and punish defendant, not to compensate plaintiff, and punitive damage award not excludable under § 104(a)(2)); *C.I.R. v. Miller*, 914 F.2d at 589 (Fourth Circuit looked to Maryland law to conclude punitive damages are "inherently different" from compensatory damages and therefore not excludable under § 104(a)(2)); *Wesson v. United States*, 843 F. Supp. 1119, 1122 (S.D.Miss. 1994) (same, applying Mississippi law); *O'Gilvie v. United States*, 1992 WL 12306 at *1 (D.Kan. May 26, 1992) (same, looking to Kansas law).

The question to be decided, then, is whether prejudgment interest is an element of available compensatory damages in Colorado personal injury actions.

B. *Under Colorado law, prejudgment interest on personal injury awards is an element of compensatory damages, not interest.*

In determining what constitutes "damages" under state law for the purposes of § 104(a)(2), courts are not bound by labels. *See, e.g., Burford v. United States,* 642 F. Supp. at 638 (N.D.Ala. 1986) (relying on Alabama caselaw to deconstruct "punitive damages" label attached to wrongful death awards under Alabama statute), *analysis approved C.I.R. v. Miller,* 914 F.2d at 591 (4th Cir. 1989). Thus, I look to Colorado caselaw interpreting C.R.S. § 13-21-101 to determine whether prejudgment interest is an element of damages for personal injury, rather than rely on the fact it is called "interest."

Under Colorado law, "prejudgment interest is an element of compensatory damages in actions for personal injuries, awarded to compensate the plaintiff for the time value of the award eventually obtained against the tortfeasor." *Allstate Ins. Co. v. Starke,* 797 P.2d 14, 19 (Colo. 1990) (citing, *inter alia, Houser v. Eckhardt,* 532 P.2d 54, 57 (Colo. App. 1975), *aff'd on other grounds sub nom. Security Ins. Co. v. Houser,* 191 Colo. 189, 552 P.2d 308 (1976)). It is "in the nature of another item of damages" wholly distinct from postjudgment interest. *Houser,* 532 P.2d at 57 (citing *Lineman v. Schmid,* 195 P.2d 408 (Cal. 1948) and *Turcotte v. DeWitt,* 131 N.E.2d 195 (Mass. 1956)).

The difference between prejudgment, or moratory,[5] interest and conventional interest is fundamental. The

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[5] In *Starke,* the Colorado Supreme Court found C.R.S. § 13-21-101 "codifies the moratory interest principle in those tort actions for personal injuries to which [the statute] applies." 797

obligation to pay prejudgment interest is tied inextricably to the concept of fault. Before liability is fixed, prejudgment interest is part of plaintiff's damage demand on a contingent and unliquidated claim and accrues until judgment enters against the defendant. *Starke*, 797 P.2d at 19; *Houser*, 532 P.2d at 57. Once defendant's liability in tort is fixed, his liability for the lost time-value of plaintiff's award also becomes fixed. Prejudgment interest is awarded to compensate for this loss and becomes a "part" of plaintiff's lump-sum damages. C.R.S. § 13-21-101; *see Turcotte*, 131 N.E.2d at 197 (damages is the word expressing in dollars and cents the injury sustained by a personal injury plaintiff; it includes *both* the original damage and whatever interest is added to make the plaintiff whole).

The obligation to pay postjudgment interest, by contrast, is not directly tied to the concept of fault. Like conventional interest, postjudgment interest accrues on a fixed indebtedness. *See Old Colony Railroad Co. v. Comm'r*, 284 U.S. 552, 560 (1932). It compensates a judgment creditor for the debtor's use, or the creditor's forbearance in demanding, payment of an amount fixed and owed by the debtor. *See Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

P.2d at 19. Moratory interest, or interest as damages, has been allowed in Colorado for over one hundred years. *Id.* at 18 (citations omitted). As viewed by the Colorado Supreme Court

> [t]he term 'moratory *interest*' is misleading, for where allowed it is awarded not as interest as such but as damages.

797 P.2d at 18 (citing *Bankers Trust Co. v. Int'l Trust Co.*, 113 P.2d 656, 665 (Colo. 1941)) (emphasis original).

It is the equivalent of "rent" for the use of funds due and owing to the plaintiff. *See Dickman v. Comm'r*, 465 U.S. 330, 339 (1984). Prejudgment interest does not fit into these definitions of interest because at the time it accrues, plaintiff is not a creditor and there is no debt fixed or owed by the defendant to him. Plaintiff can neither demand, nor forbear from demanding, payment.

I conclude as a matter of Colorado law, prejudgment interest is an element of damages compensating the personal injury plaintiff for all injuries caused by defendant's tortious conduct, including the lost the time value of his damages award. It is not "interest" as that term is defined and generally understood.

The United States argues a determination that prejudgment interest is "damages" under Colorado law does not support a conclusion that prejudgment interest is "damages" for the purpose of § 104(a)(2). Mot. Dismiss Amended Complaint at 11, *citing Aames v. Comm'r*, 94 T.C. 189, 192-93 (1990). Based on my analysis in Section II(A), *supra*, I find this argument unpersuasive. The Internal Revenue Code and its regulations are vague at best as to what constitutes an "amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights" (Treas. Reg. § 1.104-1(c)). Under the principle set forth in *Erie*, I must look to Colorado law to determine the type and nature of "damages" available in Colorado personal injury actions.

Though not entirely clear, the *Aames* opinion upon which the United States relies appears to concern the excludability under § 104(a)(2) of postjudgment, rather than prejudgment, interest. *See* 94 T.C. at 190 (interest

awarded from date jury verdict against attorney reduced by trial judge to the date reduced verdict affirmed by court of appeals). Moreover, none of the cases cited in *Aames* involved the taxation of personal injury damage awards or § 104(a)(2). *E.g., Wheeler v. Comm'r,* 58 T.C. 459 (1972) (excludability of damages awarded in breach of contract action); *Kieselbach v. Comm'r,* 317 U.S. 399 (1943) (excludability of interest on condemnation award under return of capital theory)[6]. Because neither breach of contract damages nor condemnation awards fall within the exclusion for personal injury damages in § 104(a)(2), I find the *Aames*'s analysis unenlightening and undeterminative of the question before me.

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[6] Cases in which interest on condemnation awards is deemed includable in income are inapposite. The interest portion of a condemnation award is expressly defined as "interest" in Treasury Regulation § 1.61-7 (a):

> Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of [f]ederal taxes.

26 C.F.R. § 1.61-6 (1991). If probative of anything, the inclusion on this list of interest on condemnation awards and the omission of prejudgment interest on personal injury awards suggests the latter is *not* "interest" within the meaning of § 61 of the Tax Code.

The United States also demurs to the *Houser-Starke* line of Colorado cases as irrelevant because they involve the interpretation of coverage issues under liability insurance policies.[7] Mot. Dismiss Amended Complaint at 11-12. I disagree. The caselaw forming the basis for the Colorado Court of Appeals' analysis in *Houser*, adopted by the Colorado Supreme Court in *Starke*, did not involve insurance policies or coverage issues. *See Turcotte v. DeWitt*, 131 N.E.2d 195 (Mass. 1955) (wrongful death action); *Lineman v. Schmid*, 195 P.2d 408 (Cal. 1948) (breach of contract action). Further, Colorado's recognition of moratory interest principles, codified in personal injury actions by C.R.S. § 13-21-101, is not limited to insurance policy coverage issues. *See generally* Tredennick & Cairns, *Collecting Pre- and Post-Judgment Interest in Colorado: A Primer*, 15 Colo. Law. 783 (1986).

Looking, as I must, to state law to determine the nature of prejudgment interest, I conclude it is an element of "damages" available to plaintiffs "on account of personal injury or sickness" and thus excludable from income under § 104(a)(2).[8]

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[7] In both *Houser* and *Starke*, statutory prejudgment interest was deemed to be an element of damages as opposed to interest and therefore subject to insurance policy limits for bodily injuries. It is interesting to note the words "demur" and "moratory" both derive from the latin *morari*, "to delay." Webster's Third New Int'l Dictionary (1976 ed.)

[8] Under my analysis, tax treatment of personal injury prejudgment interest under § 104(a)(2) may vary from state to state. This fact alone, however, is immaterial. As has long been a fundamental principal in tax law, the constitutional requirement

C. Kovacs and its progeny.

I am aware my conclusion in this case is different from that reached by the United States Tax Court in *Kovacs v. Comm'r*, 100 T.C. 24 (1993), *aff'd in unpublished disposition*, 1994 WL 253035 (6th Cir. June 9, 1994) and its progeny. *E.g.*, *Rice v. United States*, 834 F. Supp. 1241, 1245 (E.D.Cal. 1993) (relying on *Kovacs*); *Burns v. C.I.R.*, T.C. Memo. 1994-284 (June 21, 1994) (same). In *Kovacs*, the Tax Court cited a disinclination to interpret the term damages in § 104(a)(2) "broadly" or "overrule" previous opinions and concluded mandatory statutory prejudgment interest awarded under a Michigan statute fell outside the scope of § 104(a)(2) and was taxable "interest" income within the meaning of § 61(a)(4). 100 T.C. at 127-28 (construing M.C.L. § 600.6013 (1987)). Because my contrary conclusion requires neither a broadening of the term "damages" nor the overruling of pre-*Kovacs* opinions, I decline to follow the *Kovacs* majority and adopt instead the analysis of Judge Beghe in dissent.

1. Pre-Kovacs Tax Court and IRS interpretations of § 104(a)(2) and its predecessors.

The conclusion I reach in the instant case conforms, rather than conflicts, with federal tax law in general and

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of uniformity is not intrinsic, but geographic. *Poe v. Sanborn*, 282 U.S. 101, 117 (1930) (citations omitted).

> Differences in state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity.

Id. at 118 (citation omitted).

the Tax Court's view of § 104(a)(2) in particular. In an opinion issued 15 days before *Kovacs*, the Tax Court reaffirmed the analysis to be applied in questions of excludability under § 104(a)(2). *See Horton v. C.I.R.*, 100 T.C. 93, 95-7 (February 9, 1993) (rejecting Fourth Circuit's limited view of excludability under § 104(a)(2) with respect to punitive damages *Miller v. Comm'r*, 914 F.2d 596 (1990)). Relying on its opinions in *Downey* and *Miller*, and the United States Supreme Court's opinions in *Burke*, the Tax Court stated:

> The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, any *damages* received on account of that claim . . . are excludable.

Horton, 100 T.C. at 95-96 (emphasis added).

The Tax Court's analysis of what is meant by the word "damages" in this context is illuminating:

> Whether the damages paid to the tort victim reflect a substitute for amounts or items otherwise taxable or a substitute for amounts or items to be enjoyed without a tax consequence is irrelevant. Thus, section 104(a)(2) permits the exclusion of damages that are a substitute for the enjoyment of a whole body or of freedom from distress. . . . Likewise, the section allows exclusion of damages that are a substitute for *amounts* or *items* that *otherwise would be taxable* or would potentially produce taxable benefit, such as income lost as a result of a personal injury or

> amounts reflecting injury to a person's business or professional reputation.

Horton, 100 T.C. at 96 n.4, *quoting Downey v. Comm'r*, 97 T.C. at 163-64 (emphasis added). The analysis is clear: when items otherwise taxable are awarded *as damages* for personal injuries, their character as "otherwise taxable" becomes irrelevant and they are excluded from income. Thus, even if prejudgment interest were "otherwise taxable," once it is awarded as damages for personal injuries, that fact becomes irrelevant and it is excludable from income.

In reaching its conclusion in *Kovacs*, the majority relies heavily on the 1933 Board of Tax Appeals decision in *Riddle v. Comm'r*, 27 B.T.A. 1339. The Tax Court credits *Riddle* with having articulated the "longstanding" judicial view that prejudgment interest is includable in gross income. *See* 100 T.C. at 129-30. As Judge Beghe points out in his dissent in *Kovacs*, the "longstanding" judicial view of prejudgment interest is, if anything, contrary to the majority's interpretation of *Riddle*. *Id.* at 155-56 (Beghe, J. dissenting).

Riddle, like *Aames*, concerned the taxability of *post*-judgment, not prejudgment, interest.[9] The Board of Tax

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[9] As Judge Beghe notes, *Riddle* concerned the taxability of postjudgment interest on a $ 15,000 award by the Mixed Claims Commission for personal injuries suffered in the sinking of the steamship Lusitania in 1915. *See Kovacs*, 100 T.C. at 154 (Beghe, J. dissenting) *discussing Riddle*, 27 B.T.A. at 1340. The interest had accrued from November 1, 1923, the date of the award, to 1928, when it was paid. *Riddle*, 27 B.T.A. at 1339. Under the law applicable to the Mixed Claims Commission at that time,

Appeals' conclusion that *post*judgment interest is "separately computed and specifically designated interest" and therefore includable in income, 27 B.T.A. at 1341, simply does not support the *Kovacs* majority's conclusion that prejudgment interest is includable in income. The more relevant case for determining the "longstanding" view of prejudgment interest is one decided three years after *Riddle, NV Koninlijke Hollandische Lloyd (Royal Holland Lloyd) v. Comm'r*, 34 B.T.A. 830, 835 (1936), in which the Board of Tax Appeals explicitly distinguished "separable" items of interest includable in income from prejudgment interest awarded as damages.

Royal Hollands involved the unlawful detention by the United States of the Royal Holland Lloyd vessel Zeelandia from October 22, 1917 to March 21, 1918. The Lloyd asserted a claim against the United States for damages arising out of the United States' refusal to let the Zeelandia leave, and tried for several years to resolve the matter through diplomatic channels. 34 B.T.A. at 831. On March 3, 1927, Congress enacted the Act for the Relief of the Royal Holland Lloyd, sustaining the Lloyd's claim and permitting it to sue the United States for damages in the Court of Claims. *Id.* at 831-32.

On December 7, 1931, the Court of Claims found for the Lloyd, finding it was entitled to recover $446,826.22,

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interest was not allowable as damages from the time of loss, but only from the time the loss was fixed and liquidated by the Commission. *Id.* at 1340. The Board of Tax Appeals concluded the $ 3,422.61 in postjudgment interest was paid to and received by the taxpayer as interest *eo nomine* and was thus includable in gross income. *Id.* at 1341.

together with interest. On July 18, 1932, the United States issued a warrant in favor of the Lloyd in the amount of $ 532,356.95 in partial payment of the judgment of the Court of Claims. 34 B.T.A. at 832. This payment included $ 84,531.73 in interest. *Id.*

On May 24, 1933, the Collector of Internal Revenue sent a letter to the Lloyd in Amsterdam stating the Lloyd had realized taxable income for the year 1932 as a result of the Court of Claims' judgment. *Royal Holland,* 34 B.T.A. at 833. The Lloyd filed the requested return, but asserted no part of the court's judgment constituted taxable income. *Id.* The Commissioner assessed a deficiency, finding the Court of Claims' award, which included interest for the period of the detention through the date of judgment, was taxable income from sources within the United States pursuant to § 119(a)(4) of the Revenue Act of 1932 (now codified at 26 U.S.C. § 861). *Id.*

The Board of Tax Appeals disagreed. It determined the judgment was obtained "as just compensation for damages for the unlawful detention of the petitioner's property." 34 B.T.A. at 834. Specifically, the Board concluded none of the payment constituted taxable "interest" within the meaning of § 119 because, "under well established rule, the 'interest' was included in the judgment as part of just compensation for damages sustained." *Id., citing Seaboard Air Line Railway v. United States,* 261 U.S. 299 (1923); *Brooks-Scanlon Corp. v. United States,* 265 U.S. 106 (1923); *Phelps v. United States,* 274 U.S. 341 (1927).

> Just compensation for the damage so suffered requires that the party damaged be made whole. An integral part of a payment for such purpose is interest covering the period of detention. In

> such a case [interest] is merely a convenient method of measuring the amount of one of the factors of damage. *It is not a separable item of interest on an obligation.*

Royal Holland, 34 B.T.A. at 835 (emphasis added).

I find the Board's analysis in *Royal Holland* instructive on the question of whether prejudgment interest (or interest awarded as damages) is a "separable" item of interest for tax purposes. The Board concluded it was not, and I decline to read the earlier *Riddle* decision as the *Kovacs* majority does.

2. "Interest is Interest"

The *Kovacs* majority invokes the following syllogism to conclude prejudgment interest awarded as damages in personal injury actions is not "damages" excludable from income under § 104(a)(2): prejudgment interest is "interest"; "interest" is not "damages"; therefore prejudgment interest is not "damages" excludable from income under § 104(a)(2). *See* 100 T.C. at 128-29. The cornerstone of the majority's analysis, and the one without which it fails, is the conclusory maxim "interest is interest." This tautology withers under scrutiny, and I decline to follow it.

a. The distinction between prejudgment and postjudgment interest.

Although a time value of money element inheres in both prejudgment and postjudgment interest, there is a long history of legal precedent treating them differently. Prejudgment interest is viewed as a part of the damages

received "on account" of the injury giving rise to a claim because it accrues while that claim is contingent, whereas postjudgment interest is considered interest *ego nomine* because it accrues on an indebtedness fixed by final court order. *Kovacs*, 100 T.C. at 142 (Beghe, J. dissenting), *citing* McCormick, *Handbook on the Law of Damages*, § 50, at p. 205 (1935); Dobbs, *Law of Remedies*, § 3.5, at p. 164 (1973). There is a sharp distinction between the two: interest *eo nomine*, "conventional" or promised interest, is paid as a term of contract; prejudgment interest, or interest as damages, is not based on promise, but awarded as a matter of law as compensation for the withholding of money or compensation due. McCormick, *supra*, at 205.

Though ignored by the *Kovacs* majority, federal tax law recognizes this distinction. As an example, Judge Beghe points to tax cases dealing with prejudment interest and the deduction under 26 U.S.C. § 163(a) for "interest paid or accrued . . . on indebtedness." *Kovacs*, 100 T.C. at 143-44 (dissenting opinion). Under the analysis in these cases, prejudgment interest included in an award on a noncontractual claim is damages, and is not deductible by the payor as "interest" or indebtedness because there is no debtor-creditor relationship between the parties until judgment is entered. *Id.*, *citing Midkiff v. Comm'r*, 96 T.C. 724, 734-35 (1991); *Bettendorf v. Comm'r*, 3 B.T.A. 378, 383-84 (1926); *Jordan v. Comm'r*, 60 T.C. 872, 881, *aff'd per curiam* 514 F.2d 1209 (8th Cir. 1975). Only after judgment enters does a debt arise and "interest" accrue for the purposes of § 163(a). *Id.*, *citing Bettendorf*, 3 B.T.A. at 382 (in fraud action, interest included in judgment as damages for the wrongful detention of money was damages, not "interest").

After *Kovacs*, then, prejudgment interest is "damages," not interest, for purposes of the deduction for interest under § 163(a); but it is "interest," not damages, for purposes of the exclusion from income under § 104(a)(2). The *Kovacs* majority provides no reasoned basis for this result and I find it anomalous. Federal income tax law long has recognized the distinction between pre- and post-judgment interest, treating only the latter as "interest" for tax purposes.

b. "Interest" is not always "interest."

The cornerstone of the *Kovacs* majority's analysis, i.e., "interest is interest," also ignores the Tax Court's own directive to "look beyond nomenclature" in determining whether an amount labelled "interest" is indeed "interest." *Albertson's, Inc. v. Comm'r*, 95 T.C. 415 (1990); *see Midkiff, supra*, 96 T.C. at 734 ("interest" label attached to 5% blight of summons damages is not determinative of federal tax consequences).

In *Albertson's*, the Tax Court undertook to determine whether amounts designated as "interest" in deferred compensation arrangements ("DCA's" between a corporate taxpayer and certain of its executive employees and board of director members were in fact "interest" deductible in the year accrued or "compensation" not deductible until paid. 95 T.C. at 420-21. Acknowledging a time-value of money element inhered in the amounts labelled "interest," the Tax Court nevertheless concluded these amounts were not "interest," but "compensation." *Id.* at 421-23. The following language from *Albertson's* reveals the gossamer of the *Kovacs* majority's analysis:

> In determining the effect of a transaction for income tax purposes, formalities such as nomenclature . . . [are] not controlling. [Citations omitted.] The important consideration is substance, not form. [Citations omitted.] The fact that certain amounts are *described* as interest by the parties and are *calculated* by applying a percentage rate per annum to some principal amount *does not mean that the amounts will be [treated] as interest for income tax purposes.* [Citation omitted.]

Id. at 422-23 (emphasis added).

The Tax Court then determined the amounts described as "interest" in the DCA's represented neither payments made by the taxpayer for the use of money "borrowed"; liabilities owed to the DCA participants for the "forbearance" of money whose payment had become due; nor "rent" for the use of funds because the DCA participants had no legal right to demand their payment as they accrued, and the taxpayer had no obligation to pay them. *Id.* at 421, 423 (citing *Old Colony, supra,* 324 U.S. at 560; *Deputy v. duPont, supra,* 308 U.S. at 498; and *Dickman, supra,* 465 U.S. at 339). Thus, it concluded, the amounts described as "interest" were not truly "interest," and could not be deducted from income under § 163. *Id.* at 423.

The *Kovacs* majority, however, engaged in no such analysis. Had it done so, it would have concluded mandatory statutory prejudgment interest, like the "interest" in *Albertson's,* is *not* "interest" for income tax purposes. Prejudgment interest is not a payment made by a personal injury defendant for use of money "borrowed"; a liability owed plaintiff for the "forbearance" of money

whose payment had become due; or "rent" for the use of funds owned by the plaintiff because at the time it accrues, the personal injury plaintiff has no legal right to demand payment and defendant has no legal obligation to pay. *See Albertson's*, 95 T.C. at 423.

Instead, the Tax Court in *Kovacs* did precisely what it directed courts not to do in *Albertson's*: It looked to the Michigan prejudgment interest statute and concluded prejudgment interest is "interest" because it is called "interest" and is calculated separately by applying a percentage rate per annum to the principal amount of the plaintiff's damages award. *Kovacs*, 100 T.C. at 128-29. By elevating form over substance, the *Kovacs* majority arrived at a conclusion unsupported as a matter of law and logic.

3. The exclusion of statutory prejudgment interest from income comports with congressional intent.

Finally, I agree with the dissents of both Judge Beghe and Judge Halpern in *Kovacs* on the issue of congressional intent. In 1982, Congress amended § 104(a)(2) to clarify the exclusion for personal injury awards applies to amounts received as periodic payments, as well as those received in a lump-sum. 1982 Periodic Payment Settlement Act, P.L. 97-473, 1/14/83 (adding the language "whether by suit or agreement and whether as lump sums or as periodic payments"), *discussed in* 4 U.S. Tax Rep. ¶ 1044.02 (1994); *see Kovacs*, 100 T.C. at 134-37 (Halpern, J. dissenting), 100 T.C. at 151-53 (Beghe, J. dissenting).

The PPSA specifically was intended to codify the law as it existed in 1982. *Kovacs*, 100 T.C. at 135 (Halpern, J. dissenting) (citing S.Rept. 97-646 (1982), 1983-1 C.B. 514, 515 and H.Rept. 97-832 (1982)). In place at that time was a Revenue Ruling, in which the IRS stated a victim of personal injuries who received damages in periodic payments could exclude from income the entire amount of each payment under § 104(a)(2), not just its present value. Rev. Rul. 79-220, 1979-2 C.B. 74. This fact, coupled with Congress's expressed intent in the PPSA to treat personal injury damages the same under § 104(a)(2) regardless of whether received in periodic payments or a lump-sum, supports the conclusion that § 104(a)(2) is intended to exclude from income the entire personal injury damages award, including prejudment interest. *Kovacs*, 100 T.C. 136-37 (Halpern, J. dissenting), 152-53 (Beghe, J. dissenting).

III. Conclusion

Under Colorado law, mandatory statutory prejudgment interest awarded in personal injury actions is an element of compensatory damages, not interest. It is therefore excludable from income as "damages" received on account of personal injuries or sickness under § 104(a)(2) of the Tax Code. This conclusion comports with federal tax law as it existed before *Kovacs*. I find the Tax Court majority's analysis in *Kovacs* unpersuasive, and decline to follow it.

Dated this 15 day of August, 1994, at Denver, Colorado.

/s/ John L. Kane, Jr.
JOHN L. KANE, JR.
U.S. SENIOR DISTRICT
COURT JUDGE